

Winter 1983

T H E BROOKINGS R E V I E W

Paul E. Peterson

on the Education Commission Reports:

*"With some exceptions, the studies do not address
the most difficult conceptual and political issues."*

William B. Quandt on Menachem Begin:

*"On the tactical level, he was doubtless brilliant,
outmaneuvering his fellow Israelis, the Arabs,
and two American presidents."*

*Harvey Galper and Eugene Steuerle
on Taxes and Saving:*

*"Although the tax code contains numerous
provisions that are designed to provide incentives
for saving, virtually none of them meets
the criteria for an effective incentive."*

Plus:

Andrew Heiskell on the Press

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Second-class postage paid at Washington, D.C.
 USPS I.D. No. 14209; Publication No. 551640; ISSN
 0745-1253
 Postmaster: Change-of-address cards (Form 3579
 should be sent to
 The Brookings Institution
 1775 Massachusetts Avenue, N.W., Washington,
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Attention: Men and Women of Letters

The scholars here at the Brookings Institution are very independent (truth to tell, some of them are downright iconoclastic), and there seems to be no Brookings party line on anything — except, perhaps, on the importance of there being no party line. It is only fitting, given the Institution's single-minded commitment to the avoidance of single-mindedness, that the *Review* begin to publish some letters from our readers. And so we will, beginning in the next issue.

If you write a letter intended for publication, please include your daytime telephone number; if your note is meant for our eyes only, make sure to make that clear. We look forward to hearing from you — about the findings and views of our authors and about the evolving format of the magazine.

———Mark Goldberg

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Did the Education Commissions Say Anything?

Paul E. Peterson

IT IS EASY TO OBTAIN agreement on broad goals for education. Except for Wackford Squeers, the Yorkshire schoolmaster whose perverse pedagogical philosophy was detailed in *Nicholas Nickleby*, we all want students to learn more, to be taught by excellent teachers, and to work in a supportive environment. It is the task of devising ways to *achieve* these goals that poses intellectually challenging and political divisive questions.

One might expect to find some thoughtful answers in the recent spate of national reports on American schools. After all, these studies were carried out under prestigious auspices, many of the country's foremost educators and lay leaders helped to shape their preparation, and the products themselves have been extraordinarily well-received. The usually cynical press has given the studies respectful attention; presidential candidates have renewed their commitment to quality schools; and interest groups (such as the National Education Association) have been impelled to rethink (or at least to restate) their positions on educational issues. In every one of the fifty states, public officials have appointed one or more commissions on education. According to the Education Commission of the States, there are currently 184 such entities busily at work.

It seems clear that the outpouring of commission and task force reports has had a profound effect on the national education debate. However, the reports themselves, upon close examination, prove to be disappointing. If we judge them by the standards ordinarily used to evaluate a policy analysis — focused statement of the problem to be analyzed, methodical evaluation of existing research, reasoned consideration of options, and presentation of supporting evidence and argumentation for well-specified proposals — they simply do not measure up. With some exceptions, the studies do not address the most difficult conceptual and political issues. Instead, they reassert what is well-known, make exaggerated claims on flimsy evidence, pontificate on matters about which there could scarcely be agreement, and make recommendations that either cost too much, cannot be implemented, or are too general to have any meaning.

The bulk of this essay is devoted to an assessment of the major findings and recommendations of the reports — and to a discussion of some of the issues and topics that they avoid. Then, I shall suggest that the inadequacies of the reports have little to do with the quality of the commissioners who signed them — indeed, one could scarcely find more thoughtful or dedicated public servants — and much to do with the nature of the commission process itself. Broadly representative commissions without responsibility or power, except for whatever influence that media attention may lead to, are ill-equipped for the task of policy analysis. I shall close by observing that

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even if the various commission reports had never been issued, American schools would be on the mend.

The Commissions and What They Found

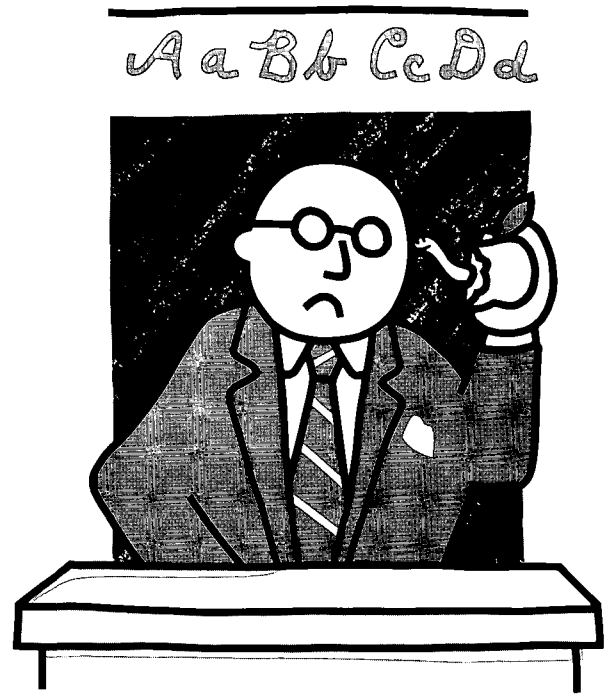
The recent studies of American education emanated from both public and private sources. The National Commission on Excellence in Education — chaired by David Gardner, president of the University of Utah — was appointed by the secretary of education and officially had the most exalted status. We shall therefore give special attention to its report. In addition, reports were issued by commissions or task forces convened by the Education Commission of the States; the Business-Higher Education Forum; the Twentieth Century Fund; the Carnegie Foundation for the Advancement of Teaching; and the National Science Board.

The discussion below will focus on these six studies. The list could be expanded, but these are the reports that received the widest public notice, and they are fairly representative of the genre. While the reports differ from one another in certain respects, some of which are mentioned below, they are more notable for the similarities of their analyses and prescriptions.

The Diagnosis: A Nation at Risk

The commissions find, first of all, that the future of the country is at stake. According to the Gardner Commission, "If an unfriendly foreign power had attempted to impose on America the mediocre educational performance that exists today, we might have viewed it as an act of war." The Twentieth Century Fund task force, favorably quoting still another commission, is hardly less apocalyptic: "Continued failure by the schools to perform their traditional role adequately . . . may have disastrous consequences for this nation." The National Science Board panel insists that "alarming numbers of young Americans are ill-equipped to work in, contribute to, profit from and enjoy our increasingly technological society." The Carnegie Foundation study criticizes the Gardner Commission for blaming schools for the "rising tide of mediocrity," but it, too, asserts that "deep erosion of confidence in our schools, coupled with disturbing evidence that at least some of the skepticism is justified, has made revitalizing the American high school an urgent matter."

These proclamations of crisis are the most arresting portions of the reports. However, the information offered in support of the claims that American schools have failed is patchy, dated, and not nearly as dramatic as the rhetoric employed. For example, the evidence that the reports present on student achievement is at best one-sided. The Gardner Commission cites a number of studies that show the scores of high school students on the Scholastic Aptitude Tests (SATs) and other tests of ability fell during the 1970s. The most comprehensive study of student performance, the National Assessment of Educational Progress, did find that the average mathematics score received by seventeen-year-



Robert Wisner

olds decreased 3.6 percentage points between 1973 and 1980. However, most of the commissions neglect to mention that the National Assessment also found an increase of 3.8 percentage points in the reading scores of nine-year-olds over roughly the same period. While the studies emphasize declines in the test scores at the high school level, they ignore the gains that have been made in the elementary schools.

The studies are quick to assume that declining high school test scores can be attributed to shortcomings of the educational system. There are, though, other factors that may be at work here — such as the increased use of drugs and alcohol, a rise in the percentage of students who live in single-parent households, and declining employment opportunities — and no one has been able to establish that changes in the classroom, independent of changes in the larger society, are to blame for drops in test results. In any case, the Gardner Commission relies upon data published several years to a decade ago. According to more recent information, student performance on the SATs has stabilized in the past two or three years and has even turned slightly upward.

Many of the reports also speak of declining public support for public education. The Carnegie study, for example, says that high schools "have been weakened by reduced support, declining public confidence and confusion over goals." While it provides no evidence for this assertion, others have pointed to the results of Gallup polls and to purported declines in support for bond referenda, drops in school expenditures, and increases in private school attendance.

Once again the evidence is mixed. If surveys show that confidence in schools has slipped over the past ten years, that slippage is no greater than the decreases that the polls find in public confidence in Congress, the military, and most other governmental institutions. It may be that as Americans are becoming more informed

politically, they are rightly becoming more skeptical of institutions and practices that they once accepted on faith.

However one interprets soft survey data, hard figures on bond votes and expenditures for public education reveal few signs of major decline. It is true that the percentage of school bonds approved in referenda fell from 74.7 percent in 1964 to 47 percent in 1972 and climbed back to only 56 percent by 1977. By 1982, though, the approval level reached 73 percent — virtually the same as the 1964 level.

To be sure, expenditures for education in constant (1979) dollars declined from \$93.2 billion in 1978 to an estimated \$85.5 billion in 1983, and average teacher salaries in constant (1981-82) dollars fell from \$22,261 in 1976 to \$20,614 in 1983. But these changes can be attributed in the main to demographic, not political, factors. With fewer children in school (a decline of over four million, or 10 percent, between 1977 and 1983) and a large pool of job-seekers in the teacher labor market, school boards needed to build fewer new classrooms and hire fewer teachers — and they were able to obtain qualified personnel at lower salaries. While this left educators unhappy, the view from the student perspective was not nearly as bad. Per-pupil expenditures (in constant dollars) did decline by 8 percent between 1978 and 1983, but only after a dramatic increase of 45 percent between 1970 and 1978. Schools today are less crowded, pupil-teacher ratios are lower, and expenditures per pupil remain substantially higher than they were just a decade ago.

Perhaps the most persuasive evidence of public school failure would be a flight by families to the private sector. Many have cited the increase in private school enrollment from 9.8 percent in 1974 to 10.9 percent in 1981 as a sign that America's confidence in its public schools is eroding. But even this modest trend in favor of private schools may be partly due to improvements over the last few years in the Department of Education's record-keeping. In any case, the percentage of pupils in private schools was still lower in 1981 than in 1960, when it had been 13.5 percent.

The commissions would have had a sounder basis for proposing reforms if they had limited themselves to the claim that schools were no longer improving as rapidly as in prior decades. Educational expenditures seem to have reached a plateau in the early 1980s, after having climbed steeply for decades, and attendance at private schools had increased perceptibly from its 1974 nadir. But these changes, far from signaling imminent disaster, may have indicated little more than a pause in what has otherwise been a continuous upward spiral in the quantity and quality of American public education. Indeed, as the concluding section of this article will indicate, there is every sign that, even before the commissions reported, schools were beginning to regain much of their earlier momentum.

This is not to say that all is well with every aspect of American education. In fact, my chief complaint about the commission reports is that by exaggerating weaknesses, they fail to pinpoint the real problems. For example, if the evidence is combed more finely, one's attention is drawn to the special troubles of the compre-

hensive American high school — an institution that most of the commissions pass over without significant comment. It is in the high school that one finds a broad decline in academic performance among black and white students alike — in reading and mathematics, in science and social studies. It is the high school senior taking the SAT whose scores have steadily declined. It is the white sixteen- and seventeen-year-old male who is leaving school at a rate 3 percent higher than in 1970. It is in the high school that adolescent resentment is most evident and the purposes of schooling most difficult to discern. Furthermore, the value of the high school diploma in the marketplace is decreasing; high school grades and teachers' recommendations carry less weight with college admissions officers than do SAT scores; and the comprehensive high school, by attempting to cater to the interests of all, seems to satisfy no one. It is significant that many of the most successful high schools in large central cities are those that have narrowed their scope and purpose—the magnet schools, performing arts schools, and vocational schools. These are increasingly preferred over the once-popular neighborhood schools — where in many cases the dominant force is peer group culture, rather than any well-defined adult purpose.

These commissions do not examine specific institutions such as the comprehensive high school, however. Instead, they survey the educational scene in such a sweeping fashion that only through the selective use of uncertain evidence can they make the case that American schools have declined. By attempting to speak to general problems, they preclude themselves from analyzing particular ones.

Objectives and Recommendations

The goals expressed by the commissions are difficult to dispute. The Gardner Commission insists (against what opposition it is hard to conceive) that "citizens must be able to reach some understanding of complex issues." It also calls for — and then defines — "excellence." For an individual learner, "excellence means performing on the boundary of individual ability," certainly a worthy ideal. For a school, excellence means setting "high expectations and goals for all learners," hardly a controversial observation. An excellent society is, not surprisingly, one that "has adopted these policies."

The Gardner Commission is not the only task force to come out foursquare in favor of excellence. The Business-Higher Education Forum finds that "a citizenry literate in science and math is critical to all sectors of American life; such skills, especially computer-related ones, will be increasingly necessary not only in offices and factories, but in schools and homes as well." The Twentieth Century Fund's task force warns that "disaster can be averted only if there is a national commitment to excellence in our public schools," and that "schools across the nation must...[teach] the basic skills of reading, writing and calculating; technical capability in computers; training in science and foreign languages; and knowledge of civics...." The Carnegie Foundation report declares that high schools "must

Table 1. Current Expenditure per Pupil in Average Daily Attendance in Public Elementary and Secondary Schools, 1929-30 to 1979-80

School Year	Unadjusted Dollars	Adjusted Dollars (1979 purchasing power) ^a
1929-30	87	\$ 373
1939-40	88	458
1949-50	209	630
1959-60	375	919
1969-70	816	1,526
1977-78	2,002	2,227
1979-80	2,272	2,001
1981-82	2,670	2,021
1982-83	2,900	2,115

Source: Department of Education, National Center for Education Statistics, *Digest of Education Statistics* (Washington, D.C.: Government Printing Office, 1980, 1982 eds.).

a. Based on the consumer price index, prepared by the Bureau of Labor Statistics, Department of Labor.

have a clear and vital mission," that the content of their "core curriculum must extend beyond the specialties, and focus on more transcendent issues, moving from courses to coherence," and that they "should help all students move with confidence from school to work and further education." The Commission of the States takes as its central thesis that "our national defense, our social stability, and our national prosperity . . . will depend on our ability to improve education and training for millions of individual citizens."

Commissions can hardly be prevented from proclaiming objectives that are so much a part of the accepted wisdom that they are truisms. If the education panels had proceeded forthwith to show us how to get the quality and excellence we all desire, their uninspired prose could surely be tolerated.

But since the proof of the pudding is in the eating, what do the studies serve up? A potluck supper that surpasses any offered by your local PTA. The delectables fall into three categories: wholesome main courses for which no recipe is given; gourmet dishes of extravagant cost; and enticing desserts that, once tasted, turn out to be nothing but sugar and air.

In the category of wholesome entrees fall such recommendations as more homework for students, more time for learning (as a result of improved classroom management), better discipline (through the use of firm but fair codes of student conduct), more leadership by principals and superintendents, and higher educational standards for teachers. Most of the studies are chock-full of this kind of advice. Wherever these recommendations can be put into effect, the benefits will doubtlessly be legion. But educators and parents know

this already. The problem is that no one has written any reliable recipes for producing the desired results. Schools are such complex institutions that policy-makers at the national, state, and local levels have been unable to produce, everywhere and anywhere, the management, school discipline, and homework assignments that they want.

The gourmet dishes that are recommended by the commissions include 10 to 20 percent increases in the length of the school year; 15 percent increases in the length of the school day; eleven months, instead of nine months, of pay for teachers (which would require a 22 percent increase in teacher salaries, apart from any cost-of-living or merit increases); reduction in the time spent by teachers on "non-educational" tasks (e.g., hall, lunch, and playground supervision); a 25 percent increase in teacher salaries over and above the rate of inflation; full-tuition scholarships for college students planning to become teachers; awards, grants, and/or special assignments for master teachers; sixty minutes of preparation time a day for every teacher; significant expansion of guidance programs; and higher salary schedules for science and mathematics teachers.

One can hardly quarrel with these recommendations. If teachers were better paid, had more time to prepare for class, were paid over the summer to develop professionally, and had fewer non-teaching responsibilities — and if students were exposed to such teachers for longer periods of time — schools would probably be better places in which to teach and to learn. It may be that some parts of these proposals will be implemented in some places, but it is not practicable to adopt all of them everywhere, given the other demands on society's limited resources. The needs of our schools must always be balanced against other societal concerns, whether these be health care, welfare provision, or military defense. Yet the commissions propose extensive and expensive educational reforms without so much as acknowledging, much less taking into account, the plethora of competing needs and expectations.

The amount of resources devoted to public education in the next decade will depend less on the enthusiasm with which the commission reports are received — or on any other political factor, for that matter — than on the state of the economy. Although the reports offer no evidence in support of their claim that better schools are essential for economic growth, one can readily find massive evidence for the reverse proposition: As a country becomes wealthier, it tends to devote more resources — both in absolute amounts and as a percentage of gross national product — to education.

It is this tendency that largely accounts for the massive increases over the past five decades in the resources devoted to our educational system. As our country has prospered during that period, teacher salaries (in 1982-83 dollars) have been boosted from an average of \$8,139 in 1930 to an average of \$21,259 in 1980. Student-teacher ratios have fallen from 25.2 to 16.6 over this same span of time, and, as shown in Table 1, per-pupil expenditures on education (in constant dollars) have increased by more than *five and a half times*.

These dramatic improvements have actually been only a few steps ahead of the country's overall gains in prosperity. For example, even though teachers' salaries have increased greatly in the past five decades, and even though their salaries today are further ahead of the earnings of the average employee than they used to be (see Table 2), teachers have never been paid more than 20 percent above that average — and if the past is a guide to the future, it is unlikely that they soon will be.

If the gourmet dishes on the menu are delicious but unaffordable, the desserts that the commissions serve are less tasty. What are we to make of the noble sentiment that "the teaching of English in high school should equip graduates to comprehend, interpret, evaluate, and use what they read"? Or of the proposition that "the teaching of mathematics in high school should equip graduates to understand geometric and algebraic concepts . . . [and] apply mathematics in everyday situations"? How can we take advantage of the suggestion that "the teaching of social studies in high school should be designed to enable students to fix their places and possibilities within the larger social and cultural structure"? These recommendations look beautiful, but in fact they are mere puff. Why urge educators to do what they already want to do without telling them anything other than that they should spend more time doing it?

Two commission recommendations that seem exempt from these criticisms — merit pay for teachers and a de-emphasis of bilingual education — have received a good deal of attention. The press, eager to find a bit of grain in so much chaff, sifted through the reports until it found these two kernels worthy of notice.

As to merit pay, the Gardner Commission urges that the salaries of teachers "be professionally competitive, market-sensitive, and performance-based." The Twentieth Century Fund report proposes "reconsideration of merit-based personnel systems for teachers." Thus, both commissions directly challenge the longstanding practice of paying teachers on the basis of education and seniority. President Reagan has endorsed the merit pay proposal, and his Democratic challengers have given the idea at least qualified support. Even teacher organizations have indicated a willingness to discuss the concept. Here, at last, is a central policy issue on which two of the commissions give the public clear guidance.

Or do they? One would expect any policy analyst offering a recommendation on such a key issue to set forth the arguments in favor of that recommendation; consider the counter-arguments and explain why they are unpersuasive; assess the costs and benefits of merit pay in countries, states, or cities where it has been practiced; and provide specific suggestions regarding the ways in which the proposed policy might be implemented. Not a single word on any of these topics is to be found in any of the reports. The Gardner Commission says feebly that merit pay "should be tied to an effective evaluation system that includes peer review," but this, its comment on implementation, raises more questions than it answers. What sort of evaluation system would be "effective"? How can we have peer review without mutual back-slapping? For its part, the Twentieth Century Fund asserts that "merit-based sys-

tems and collective bargaining are not incompatible." We are relieved to hear the news, but what is the evidence? How do the two arrangements complement one another? Specifically, how can teachers unite to promote and defend their common interests through collective bargaining while fine distinctions in quality are continuously being made among them? On these and other tough questions, the commissions maintain a Sphinx-like silence.

Three commissions discuss the role of foreign languages in American schools. The United States has traditionally been rigidly monolingual in its public education. It now has a growing population of Hispanic immigrants who are more likely to maintain their separate linguistic capacities than the members of any previous immigrant group — the reasons being geographic proximity to the homeland, frequency of return visits, and the continuing flow of in-migration. Thus, language instruction is certainly an especially timely issue and one well worth considered attention.

Indeed, the question has become so urgent that most of the commissions simply duck it. Only the Twentieth Century Fund task force is bold enough to address the issue of bilingualism directly. In a passage given extensive media attention, the panel recommends that "federal funds now going to bilingual programs be used to teach non-English speaking children how to speak, read, and write English." While this statement seems to place the task force squarely in opposition to current national policy, in fact the group's report does not take on the central point of controversy in the debate about bilingual education: Does a child learn English more quickly if taught only in the English language? Or does the child master English more quickly and acquire greater self-confidence if, while learning English, he or she is taught other subject matters in his or her native tongue? On this crucial question, the task force offers no insights.

Table 2. Teacher Salaries as Compared to Average Employee Earnings in All Industries

Year	Elementary and Secondary Teacher Salaries	Average Earnings of Full-time Employees in All Industries	Percent Above Average Received by Teachers
1929-30	\$ 1,420	\$ 1,386	2.4%
1939-40	1,441	1,282	12.4
1949-50	3,010	2,930	2.7
1959-60	5,174	4,632	11.7
1969-70	8,840	7,334	20.5
1975-76	13,120	11,218	16.9
1980-81	18,409	16,050	14.7

Source: National Center for Education Statistics, *Digest of Education Statistics* (Washington: Government Printing Office), 1982, p. 57.

What the Commissions Did Not Say

It is conceivable that most of the commissions regarded bilingual education as too peripheral an issue to be worthy of their attention. But it is difficult to imagine a rationale for their evasion of central organizational and governmental questions. If in fact there is a crisis in American education — if in fact we know what we want and we know how to do it — then surely either those in charge have been derelict in their duties or current institutional arrangements preclude effective action.

There were plenty of organizational options that the commission could have considered. Deregulationists have insisted that the federal government remove itself from educational policy-making. Educational interest



groups, notably the National Education Association, have said that schools will not be adequately funded unless and until the federal government finances one-third of their total budgets. Many state legislators have insisted that states mandate specific performance standards for individual schools. Decentralizers have called for fewer state mandates and more flexibility for local school principals.

Perhaps the most innovative type of reform that the commissions might have suggested is a reorganization of secondary schooling. As noted earlier, it is in the last years of high school that student attainment has fallen most precipitously and that student dissatisfaction has been expressed most clearly. If the commissions actually believed that the nation was at risk, they should have shouldered the responsibility of proposing fundamental reforms in the last years of secondary schooling.

For example, they might have recommended granting a two- to four-year tuition voucher to every sixteen-year-old, for use at any accredited institution at any time before the recipient reaches the age of twenty-five.

A plan of this sort would take advantage of the current administration's interest in nonpublic schools and focus it on the stage in the educational process at which it makes the most educational sense. It would also exploit the fact that sharp declines over the rest of this decade in the number of adolescents — between 1985 and 1990 the population of fourteen- to seventeen-year-olds will fall by 11.3 per cent — will mean that the supply of secondary school facilities will exceed the demand for their use. Shrinkage of the supply will inevitably occur over the next few years. Which schools disappear can be determined either by political considerations or by the choices that students make.

Choice is already the hallmark of postsecondary institutions. At the age of seventeen or eighteen, young people are given a plethora of options that range from private college to state university, from junior college to vocational training center. Even at the secondary level, alternatives to daytime public schools attracted 21 per cent of those receiving a high school diploma or its equivalent in 1980. Just over 13 per cent received degrees by earning a high school equivalency certificate or by attending evening schools, while nearly another 8 per cent received their degrees from private schools. At a time when teenagers are becoming more mobile and independent, they need to be given a greater sense of autonomy in their schooling. A growing number of students now attend schools without walls (high school programs that draw on resources throughout a city instead of limiting themselves to what is available in any one school building), participate in career training programs, and travel long distances from home to attend schools of their choice. If a tuition voucher arrangement facilitated still more choice and differentiation in secondary education, schools might become more responsive to the social, educational, and vocational needs of young adults. Those students who wanted to "stop out" could postpone their education until they were ready to make best use of it.

I have described the tuition voucher option not because I believe it will resolve the "crisis" in education, but because it is an example of the kind of far-reaching but still practicable proposals the commissions might have put forward. A committee appointed by the National Academy of Sciences to examine vocational education in depressed areas did recommend vouchers for low-achieving high school students, but none of the high-visibility commissions with broader mandates even comes close to proposing a major organizational innovation. All of them seem to want to keep the basic organizational arrangements now in place — although they do not say that with any conviction either. A crisis is discovered and various reforms are proposed, but in the end no institutional change is deemed necessary to push back the "rising tide of mediocrity."

On governance matters — as on most others — the Gardner Commission takes the clearest non-position; it says only that "state and local officials... have the primary responsibility for financing and governing the schools," while "the Federal Government has the primary responsibility to identify the national interest in education." The task force of the Education Commission of the States weighs in with this observation: "It is

our strong conviction that the states and local communities must have the chief responsibility for supporting the schools and for making educational policy . . . But . . . this is no time for the federal government . . . to shrink suddenly from the issue of education as a national priority."

The Carnegie report, which took the American high school as its central focus, could have been expected to address forthrightly the problems of the comprehensive high school. But that phrase does not even appear in its chapter of recommendations. In fact, the possibilities for organizational reform are virtually ignored, save for the peculiar suggestion that the federal government fund residential academies for gifted students — an undertaking that either would be extraordinarily expensive or would serve so few students that it could hardly address the larger issues at stake. Otherwise, the Carnegie study limits its recommended governance reforms to the following shibboleths: "The States should recognize that their overriding responsibility to the schools is to establish standards and to provide fiscal support, but not to meddle . . . To achieve excellence in education the federal government also must be a partner in the process."

Some minor adjustments in the organization of our school system are suggested — the Twentieth Century Fund, for example, proposes a Master Teachers Program and special federal fellowships for failing students — but the overwhelming, if latent, message in all the reports is that *very little needs to be done differently*. Despite their claims that school systems have deteriorated, the commissions evidently believe that with only the slightest organizational modifications these systems can correct themselves. All that is needed is more money, more public confidence, and more exhortation from on high.

Why Commissions Say What They Do

As we have seen, at least six separate educational commissions operating independently of one another all produced policy analyses of dubious value. Why? It could hardly have been the fault of the people involved. Most of the commission members were distinguished Americans with able minds and broad experience. While I was not privy to the deliberations of all of these commissions (and, therefore, the following thoughts are somewhat speculative), I am convinced that their difficulties probably lay in the organizational and political realities of commission decision-making.

As institutions, most commissions are ill-equipped to perform the tasks assigned to them. Commissions are usually asked to address broad public problems that in principle are not susceptible to easy solutions. They typically consist of distinguished citizens who are broadly representative of diverse interests. They are expected to produce reports expeditiously and with near unanimity. Commissions ordinarily have no power or authority except for whatever they can derive from their own accumulated prestige. To have an im-

pact, their findings must be widely discussed and disseminated. Given these organizational and political restraints, a "successful" commission report is likely to have several not altogether satisfactory characteristics.

1. *The report is almost certain to exaggerate the problem it addresses.* If a commission explores a topic and finds that little is wrong or that not much can be done about what is wrong, the report will never reach the threshold of public attention. The major exception to this rule of thumb occurs when a commission is asked to investigate a great disaster or tragedy in order to insure that it will not be repeated. Under those circumstances, a commission may be tempted to stress the idiosyncratic and unpredictable (e.g., it was one maniac acting alone who shot the president). But when the public's attention is not already riveted on the topic at hand, a commission (or its staff) is tempted to dramatize its subject matter. This usually requires selective use of evidence and a profusion of strong rhetoric. Careful reasoning, balanced assessment of available information, and cautious interpretations are unlikely to survive the commission's need for public attention.

2. *The report will state only broad, general objectives.* Although commissions tend to be bold in finding serious problems, they are less adventurous in stating their own goals. A representative commission is likely to have within it diverse views on such matters as what schools should do and how they should do it. Agreement is more likely on generalities like excellence and quality, less likely on such hypothetical recommendations as "no more than twenty minutes of physical education, because it has no redeeming academic value."

This sort of outcome is especially probable when the charge to a commission is as broad and general as that given to the education panels. The secretary of education asked the Gardner Commission "to make practical recommendations for action to be taken by educators, public officials, governing boards, parents, and others



Robert Wiser

*The education commissions
had no authority,
and therefore they had no
responsibility.*

having a vital interest in American education." At a similar level of specificity, the Business-Higher Education Forum was asked by the president to prepare recommendations designed "to strengthen the ability of this nation to compete more effectively in the world marketplace."

In this regard, the education commissions differed from the National Commission on Social Security Reform, whose charge was quite specific. The social security system was on the verge of bankruptcy, and the commission was asked to review a range of already developed proposals for tax increases and expenditure reductions. Even though the commission's work was complicated by the fact that it could only make imperfect estimates of future social and economic trends, it nonetheless had a well-defined goal—fiscal solvency—that disciplined its considerations.

Education commissions worked within a much more nebulous framework, and they lacked the internal capacity to define more narrow objectives that could be addressed concretely.

3. *The report will recommend changes that are beyond current technology and resources.* The education commissions had no authority, and therefore they had no responsibility. They could insist upon better classroom management, because no one could hold them responsible if it did not materialize. They could call for a 25 percent salary increase, because they did not need to collect the revenue to pay for it.

By contrast, the social security commission had great power and therefore inordinate responsibility. Since its membership was appointed in equal numbers by the president, the Senate, and the House, and since it included representatives of the leaders of both political parties, the commission had all but the formal capacity to enact its recommendations into law. No one expected the social security commission to recommend vacuous or impractical reforms; the participants bore too much responsibility for their actions for that to occur. Instead, the issue was whether any agreement at all could be reached, given the diversity of ideological perspectives at the table and the extraordinary political interests at stake.

Commissions lacking such power and responsibility reach consensus by including every member's favorite proposal in the list of recommended solutions. As long as a proposal does not offend any represented interest except that of the poor taxpayer, then it can be added to

the collection. Members spend much of their time at commission meetings becoming acquainted with one another. Since members are not paid for their participation, the activity is expected to be enjoyable and intrinsically satisfying. Harsh disagreements, rigorous cross-questioning, and hard-nosed analysis of proposed solutions are more the exception than the rule. Only when a commission member perceives a vital interest at stake does he or she employ the kind of rigorous analysis that this same person might routinely undertake in other spheres of activity.

4. *The report will not spell out the details of its proposed innovations.* The more detailed a recommendation, the less likely the commission is to agree on its virtue. Differences of opinion can be smoothed over by leaving crucial questions of implementation to someone else. Since the commission does not know whether even the general concept will win wide acceptance, struggling over the details does not seem worth the effort.

5. *The report will seldom call for institutional reorganization.* The most controversial proposals are those that call for a rearrangement of institutional responsibilities. Broadly representative commissions in education typically include a school board member, a superintendent, a representative from a state department of education, a dean of a school of education, a teacher, a representative from the business community, a trade unionist, and minority representation. (Commissions lacking such breadth will be accused of being narrow, partisan, and self-serving; their recommendations will not have the prestige required to win wide publicity and general applause).

Such a group is unlikely to agree on organizational reforms expressed even in the most general terms. While substantive policy proposals such as merit pay may be stated vaguely enough to gain general consent, reorganization proposals have too discernible a set of political consequences to be easily compromised. As a result, the "hot potatoes" are simply set to one side (after a half-day or so of heated discussions).

6. *The report will poorly document the value of the solutions it proposes.* Documentation is a painstaking, time-consuming, boring activity. It requires days of reading, gathering, and assessing information, followed by hours of careful writing and editing. It is staff work!

The reasons the staff does not do the work are legion. Understaffing is one factor. Commissions are expected to be cost-effective, to deliver a large bang for few bucks. One full-time staff member, with overhead, may cost nearly as much as all the other commission expenses combined. That staff member spends inordinate amounts of his or her time planning meetings, handling expense vouchers, preparing minutes, drafting versions of the report, and handling internal and external communications.

But even if staff were ample, the necessary documentation work would probably not be done. While a good staff can document the problem, it cannot gather evidence to assess proposed recommendations until these are agreed on by the commission. Unfortunately, the commission typically agrees on its proposals only at the end of its term of office — which in all probability has already been extended beyond the originally antcipat-

ed terminus. In the first months of a commission's life, members become acquainted, listen to experts discuss the problem, receive testimony from interested groups, and explore alternatives. By the time agreement is reached, it is too late to look at the evidence. Moreover, staff-produced analyses in the final stages of manuscript preparation might even sabotage the commission process. Detailed assessment of a proposal would uncover unanticipated difficulties that, if brought vigorously to the commission's attention, would be perceived as a staff attempt to circumvent the commission's policies. In the end, the staff, no matter how knowledgeable and industrious, concludes that it is better to leave certain problems unmentioned than to spell out and justify proposed recommendations in detail.

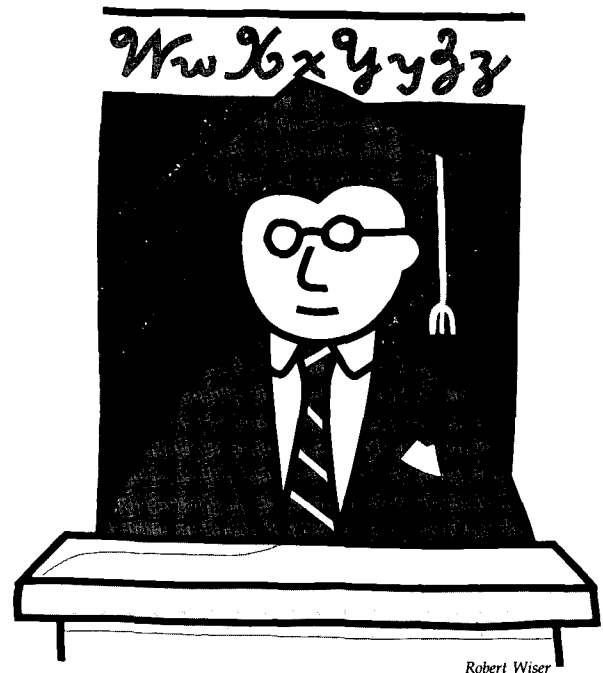
Commissions do have their functions in American politics, but fact-finding, rigorous analysis, and policy development are usually not among them. Commissions are more appropriate for dramatizing an issue, resolving political differences, and reassuring the public that questions are being thoughtfully considered. Oscar Wilde said it the best: "On matters of grave importance, style, not sincerity, is the vital thing."

The Commissions May Seem to Succeed

Although the commission reports have limited value, they may, as luck would have it, come to be seen as having had a major impact. Not only have the reports been given widespread publicity and not only have they spawned new activity in many state legislatures, but it would not be surprising to find that in the next few years test scores improve, public confidence returns, and fiscal support for public education increases.

Several factors point in this direction. First, student performance has already begun to improve, especially among pupils now at the elementary school level and, most recently, at the junior high school level. As these students proceed through the educational system, the test scores of high school students, including those taking the SATs, can be expected to increase. Secondly,

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Robert Wisner

many of the changes wrought by school desegregation have now been absorbed by public schools. Periods of social transition are likely to affect adversely the particular generation that undergoes the change and disruption. Those who follow enjoy the benefits of the new regime without having the costs of transition. Thirdly, there is some reason to believe that the United States is now entering a period of sustained economic growth. To be sure, fiscal deficits, third-world debts, and possible oil interruptions remain potential threats to a sustained recovery. But if the current economic resurgence continues, schools will be among the beneficiaries. Even if federal aid does not increase, state and local governments, which currently finance 90 percent of the cost of public education, can be expected to commit to education substantial portions of any new resources that a more productive economy generates.

States and localities may be even more prepared to move in this direction because a number of national commissions have urged them to do so. But the commissions seem more to have reflected than to have spawned a widespread revival of interest in schools. Commission reports appear to have been well-received in spite of their contents, because Americans had already become interested in school quality. Even before the reports were issued, bond referenda were being approved with increasing frequency; candidates for state office were already finding educational issues to be a key component of a winning campaign strategy; and Democratic presidential hopefuls, calling for renewed attention to the nation's human capital, had identified education as a major campaign theme.

In the United States, one seldom knows whether leaders are shaping or following public opinion. In the case of the commissions, I suspect it has been mainly a matter of following. But by running fast to the head of the pack and shouting loudly en route, the commissions may have made an impression after all.

Menachem Begin: A Past Master at Negotiation

William B. Quandt

NOTHING SO SHARPLY CONTRASTED with Menachem Begin's political career as his manner of leaving it. The reclusive, tired, reportedly despondent figure of recent months bears little resemblance to the fiery, determined, and often rigid person who presided over Israeli political life for the crucial six-year period following his selection as prime minister in mid-1977. Begin came to power after a lifetime of political struggle—after years spent in prison, in the underground, and in opposition, often relegated to the fringes of power. He had only a brief chance to translate into reality his compelling ideological and historical vision of Eretz Israel, powerful and independent, able to offer refuge to Jews of the world, with borders stretching from the Jordan River to the Mediterranean Sea.

It is too early to know what history's judgment of the Begin era will be, but his legacy is clearly a controversial one that will long be debated in Israel and elsewhere. He can take credit for reaching peace with Israel's largest Arab neighbor, Egypt, but as Begin fades from the scene, so also does the promise of a real, lasting peace between Israel and the Arabs. Even the relationship with Cairo can be described only as a "cold peace," and many Israelis wonder how long it can last. On the domestic front, Begin's retirement coincided with a severe economic crisis that revealed the tenuousness of the prosperity that Begin's economic policies had generated. That shaky prosperity was enough to get Begin reelected in 1981, but it was built on massive debt that entailed great dependency on the United States—and thus susceptibility to a whole range of pressures. And Begin's dream of a revival of Jewish migration to Israel has not been realized. Instead, many Israelis leave their country each year, some never to return.

If, as many reported, Begin was in a state of depression at the time of his retirement, the most likely reason was the unending tragedy of Lebanon, where Israel fought what was, in the eyes of its own citizens, its least justifiable war. Whatever grand design may have convinced Begin to launch "Operation Peace for Galilee" in June, 1982, little of it could be seen in the murky Lebanese realities of late 1983.

Over 500 Israelis, and many thousands of Lebanese and Palestinians, died in a war that left the Middle East as far from peace as ever. True, the Palestinian Liberation Organization (PLO) was driven from Beirut, but Palestinians have not ended their struggle for control over at least a portion of what they consider to be their homeland. Syria, Israel's most vocal enemy, managed to emerge from the military setback in Lebanon to claim a surprisingly strong position a year later. The Soviets, who stood by while Israeli bombs rained down on Beirut, rushed to resupply the Syrians in late 1982 with advanced weapons and to strengthen Moscow's position in the

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region. And Israel's Christian allies in Lebanon have not lived up to Begin's high hopes. The laboriously negotiated Lebanese-Israeli accord of May 17, 1983, remains a dead letter. All in all, Begin and his supporters have little to show from the war in Lebanon.

If there is anything that Menachem Begin can take quiet satisfaction from at the end of his tenure, it must be the knowledge that Israel's presence in the West Bank, Gaza, and Jerusalem is all but permanent. When he entered office as prime minister, the official policy of the government of Israel was that portions of the West Bank and Gaza would be returned to Arab control in the context of a peace settlement. Begin abruptly changed Israel's policy, declaring that even in exchange for peace and recognition, Israel would not return these territories—which he considered to be a “liberated” part of Eretz Israel. After six years and massive investments in settlements, roads, and infrastructure, Israel's hold on these areas seems assured, and American and Arab efforts to keep open the possibility of trading “territory for peace” have failed.

Many of Begin's admirers, and most of his critics, feel that the war in Lebanon was really fought to strengthen Israel's grip on the West Bank and Gaza. If that was in fact his motivation, then Begin may feel that the war served some purpose. But one must still ask whether future generations of Israelis will thank Begin, or blame him, for making Israel responsible not only for the territory of the West Bank and Gaza, but also for the more than one million Palestinian Arabs who live there. If Israel keeps the territory and wishes to remain true to democratic principles, it will become pluralistic and binational, and the main *raison d'être* of the Zionist experiment—creation of a Jewish state—will have been forfeited. Or Israel can remain a Jewish state, but one that rules in colonial fashion over 35 to 40 percent of its population—a restive and articulate Palestinian minority that is deprived of political rights.

Tactician or Strategist?

Menachem Begin is a hard man to assess fairly. His strong personality, his old-world demeanor, his ideological bent, and his rhetorical flair arouse strong feelings among his supporters—who chanted during his election campaign, “Begin, King of Israel”—and his detractors. His courtly manners, even his sense of humor, could be disarming, while his rigidity and verbal excesses often provoked antagonism.

What most people never saw was Begin the politician, the man who shrewdly weighed the pros and cons of issues, measured public opinion while seeking to mold it, judiciously leaked stories to the press when it could help his cause, knew the value of compromise, and appreciated the realities of power. This was Begin the tactician, maneuvering, seeking to seize the initiative from others, possessing a fine sense of timing, and using to good effect his reputation for intransigence.

Begin the politician was a master tactician, made more formidable by his absolute certainty about the justice of the goals he was pursuing. These were not personal goals of wealth or prestige. Begin lived modestly and, while a very proud man, did not suffer from



Lise Gladstone

excessive egotism. His drive for power seemed deeply rooted in the trauma of his own people. He was determined to make Israel a strong Jewish state in as much of its ancestral homeland as possible. His world was one in which anti-Semitism was an ever-present danger, and opposition to Israeli policies, even by Jews, was seen as tantamount to being anti-Jewish.

Begin was an educated man, yet very parochial. His knowledge was primarily of Europe and European Jewry. Although he was obsessed by the threat to his country posed by Arab nations, he knew little about these neighbors. Unlike Abba Eban or Moshe Dayan, he never learned Arabic. He rarely met with any Arabs, even when he was trying to promote the virtues of his proposals on Palestinian autonomy to the Arabs living under Israeli occupation. In fact, he spent almost no time at all in the areas of Judea and Samaria, to which he was so deeply committed.

If there is anything that Menachem Begin can take quiet satisfaction from at the end of his tenure, it must be the knowledge that Israel's presence in the West Bank, Gaza, and Jerusalem is all but permanent.

No doubt Begin had a moral blindspot concerning the Palestinian question. This seems to have made it easier for him to characterize the Palestinians and their leaders as irrevocably hostile to Israel. To have accepted the possibility of compromise and mutual recognition, as he did with Egypt, would have obliged him to consider the return of the West Bank to Arab control. This, on ideological and historical grounds, he would not consider. It was on the Palestinian question—and especially on the issue of territorial compromise over what Begin always called Judea and Samaria—that he was unyielding.

Once one understands that Menachem Begin's touchstone was the integrity of Eretz Israel, then much else follows in understandable ways. Begin made peace with Egypt, on terms that included the return of all Sinai, as a step toward incorporating the West Bank. Begin ordered the army into Lebanon in the summer of 1982 to destroy the PLO, but not—as many of his Lebanese allies, and probably General Ariel Sharon, would have wished—to drive out the Syrians. Begin proposed an autonomy plan for the West Bank as a means of deflecting U.S. pressure, but on a day-to-day basis focused on building a strong, irreversible Israeli presence in the territories, not on encouraging Palestinians to assume more responsibility for their own lives.

It was Begin's fundamental strategic judgment that Israel could be secure only if it could defeat its enemies in battle and if it could control all of the territory west of the Jordan River. So intent was he in the pursuit of these goals that he neglected many domestic issues, both economic and social. He may also have missed opportunities to reach tacit or explicit accommodations with King Hussein of Jordan and with Palestinians in the occupied territories. He certainly damaged Israel's standing in American public opinion. And he saddled Israel with the burden of having to decide what to do with more than one million Palestinians of the West Bank and Gaza.

Historians of a later era will have to judge the strategic vision pursued by Menachem Begin—and that vision may prove to be so controversial that no consensus on its merits will emerge. What will be agreed upon by all those who saw Begin operate in his prime is his skill as a politician. On the tactical level, he was doubtless brilliant, outmaneuvering his fellow Israelis, the Arabs, and two American presidents. Nowhere was his political acumen more clearly demonstrated than in the Camp David negotiations.

Begin at Camp David and After

At Camp David, Begin was in top form—sure of himself, skillful in his tactics, clear in his objectives, and tenacious in negotiating with two formidable leaders, Anwar Sadat of Egypt and President Jimmy Carter. Begin left Camp David having achieved far more of his objectives than Sadat and Carter achieved of theirs. Let us look for a moment at how he did it.

Soon after becoming prime minister, Begin flew to Washington to meet with Carter. It was immediately clear that Israeli policy had changed. Begin distrusted any substantive role for the United States in negotiations, fearing that Washington would tilt in favor of the Arabs. He sought to restrict his discussions with Carter to procedural issues and to a sweeping review of history. In addition, he placed great emphasis on Israel's strategic importance to the United States in the East-West confrontation.

When Carter managed to get him to focus on substance in a private talk on July 19, 1977, Begin spelled out clearly that he would agree to relinquish most of Sinai in return for peace with Egypt, but that he would never accept any "foreign sovereignty" over the West Bank. In response to Carter's request that he promise not to build more settlements in occupied territory, Begin said that he could not make such a promise, but that he would do his best to act with restraint. In return, he asked Carter not to talk about the 1967 lines as the eventual secure and recognized borders of Israel, and he urged Carter not to repeat the phrase "Palestinian homeland."

From this first encounter, it seemed clear to the Americans present that Begin sought a separate peace with Egypt and would not willingly make any concessions on the Palestinian issue. When looked at closely, his position involved a major departure from that of his predecessor in one respect. The Labor governments from 1967 to 1977 had opposed the creation of a Palestinian state, but they had been prepared to apply the "territory for peace" formula of U.N. Resolution 242 to a future agreement with Jordan—prepared, in other words, to return some, but not all, of the West Bank to Jordanian authority in the context of peace. Begin, who had quit the cabinet in 1970 when Israel formally accepted 242 with this interpretation, staunchly maintained that Israel was under no obligation to withdraw from any of the West Bank, even in the context of peace. In his view, Jordan had no valid claim to sovereignty over any of this territory. In a novel twist, Begin now said that he did accept 242, but that he interpreted its withdrawal provision as applying only to Sinai.

Throughout much of the next year, the United States and Egypt tried to get Begin to agree to a freeze on settlement activities in the occupied territories and to an understanding that the withdrawal provision of U.N. Resolution 242 did indeed apply to all fronts, including the West Bank. Begin was masterful at resisting all pressures. The ability and single-mindedness of the man were much in evidence in the months leading up to Camp David.

On one level, Begin tried to go behind Carter's back to see if a separate deal could be struck with Sadat. Several secret contacts took place in late 1977, along with the highly publicized and politically significant bilateral meetings between Begin and Sadat in Jerusalem in November and Ismailia in December. Sadat soon concluded that his position was too weak to deal with Begin alone, so he asked Carter to rejoin the negotiations. However, Begin had already staked out his basic position. In essence, he offered Sadat most of what he wanted in strict Israeli-Egyptian terms, while refusing to give Sadat anything significant on the Palestinian question. Initially, Sadat refused the offer, and during most of 1978 he tried to use Carter to pressure Begin to be more forthcoming.

Begin simply refused to budge. To ward off U.S. and Egyptian initiatives, he came up with a plan of his own in mid-December, 1977, that he called "home rule" for the Palestinians. It was vintage Begin. A formal document was drawn up with excessive detail. Begin lobbied hard for his plan in the United States, and in one meeting listed for Carter all the prominent Americans who supposedly supported it. When Carter expressed a mildly positive opinion about the plan, Begin immediately told the press that the president had termed it a "fair basis for negotiations." Although he never won full American support for the plan, he did insure that his ideas became the focus of discussion. Eventually the "home rule" proposal was modified and redefined. The Camp David accords did provide for a five-year transitional regime for the West Bank and Gaza during which Palestinians could exercise "self-government" or "administrative autonomy." This was an outgrowth of Begin's original idea.

In addition to recognizing the importance of controlling the agenda for negotiations, Begin also knew how to turn to good advantage his reputation for intransigence. He would resist mightily making even the most insignificant verbal concessions, so that when he would finally decide to give an inch it would seem like a yard. Sadat became thoroughly exasperated by this tactic, which meant that he paid little attention to words and details. Begin was able to get most of what he wanted in the final agreements. Carter also disliked the tactic, but he could never find a way to counter it. Instead, he and Secretary Vance often ended up negotiating the precise words of a text on Sadat's behalf.

Begin also had a great sense of timing. He would push negotiations to the breaking point and then at the last moment would give just enough to get what he really wanted in return. For example, at Camp David he was unwilling to agree, until the next to the last day of discussions, to remove Israeli settlements from Sinai. By then, Sadat had already threatened to walk out

once, Carter had nearly concluded that the talks would end in failure, and a whole host of issues were still left to be resolved. Finally, in one marathon session of negotiating, Begin yielded on the question of settlements in Sinai and in return won removal from the agreement of several key points that would have held Israel to the "peace for withdrawal" formula on the West Bank.

In March, 1979, in one of his most remarkable performances, Begin once again took negotiations to the brink of failure before edging back just enough to ensure success on his terms. President Carter decided to travel to the Middle East in a last attempt to clinch an agreement between Sadat and Begin. By the time he arrived in Jerusalem, only a few significant issues remained to be solved. One involved a footnote to one article of the treaty. The Egyptians wanted a phrase changed—from "does not derogate from" to "does not contradict." Begin maintained that this change would nullify the entire sense of the treaty, an implication that none of the native English speakers could see in the proposed revision. Much of one day was spent in Jerusalem with the American and Israeli delegations looking through dictionaries and thesauruses to find substitute language.

The spectacle of the president, the secretary of state, the secretary of defense, the assistant to the president for national security affairs, and half a dozen of their top aides trying to find a word acceptable to Begin must have given him a sense of power and importance. Finally, Begin came into the room and announced that he had found a solution. He proposed the phrase "does not affect," which had exactly the opposite meaning from that which was intended. Secretary Vance replied that "does not contravene" seemed more appropriate. Begin hesitated, gravely acknowledged that this was a serious proposal, and said that he would have to discuss it with his cabinet.

A few hours later the answer came back: Begin could not accept "does not contravene," but he could accept "is not to be construed as contravening." The Americans, who never quite understood the game that was being played, saw no difference, shrugged, and felt relieved to have gotten over one more hurdle. Of course, the other important issues that could have been discussed during those long hours were all still pending, to be dealt with in haste on the morning of Carter's departure from Israel. Begin had once again put his reputation for rigidity and verbal precision to good use for major political purposes.

In the end, it was this combination of single-mindedness, tenacity, and toughness, coupled with a real understanding of the uses of power and persuasion, that made of Menachem Begin a larger than life-size figure. Whether or not his vision of Israel is one that his own countrymen will want to live with for long, he has left them a powerful legacy. And Begin's name will be linked with other great Israeli leaders—Ben Gurion and Golda Meir, for example—who in their time held him in contempt. So, as Menachem Begin eases his grip on Israeli political life and passes the mantle to his chosen successor, he must find some satisfaction in knowing that history will treat him seriously, if not necessarily kindly.

Tax Incentives for Saving

*Harvey Galper and
Eugene Steuerle*

THE PROMOTION of a healthy rate of economic growth has long been a central goal of public policy. The two principal categories of initiatives deployed in pursuit of that goal have been macroeconomic measures and structural tax incentives. The tax code now contains a variety of provisions intended to encourage saving and investment — and, through them, growth. Because of the lagging performance of the economy in recent years, many new incentives for household saving have been proposed. Unfortunately, few supporters of these proposals or of the saving provisions now on the books have developed a systematic conception of the attributes required for a saving incentive to be effective. In this article, we will grapple with that crucial issue.

Two disclaimers should be noted at the outset. First, we are not suggesting that increasing household saving is the only, or even the most important, goal of structural tax reform. An equitable distribution of tax burdens, minimal distortion of economic choices, and effective administration of the tax system must be considered as well. Each of these goals may place serious constraints on the possibilities for changing the tax structure to promote saving. Equity objectives may limit the extent of tax changes in particular income classes. The goal of a minimally distorting tax system requires that consideration be given to the impact of potential saving incentives on labor supply, consumption patterns, and resource allocation in general. Moreover, a tax system should be capable of being administered without imposing excessive paperwork or record-keeping burdens on the taxpaying public. Tax reforms that are designed to promote saving ought to be judged along these dimensions as well.

Second, we make no claim that tax incentives, even if well-designed, will necessarily generate substantially higher saving rates; saving may just not be very responsive to tax changes that increase after-tax rewards. It is possible, however, to identify the criteria that incentives must satisfy if they are to have any chance of increasing saving levels.

In this essay, we first set out those criteria. Then we review existing tax incentives and evaluate them in terms of the criteria. Lastly, after determining that current incentives are decidedly deficient, we describe several tax changes that would constitute genuine saving incentives.

The Internal Revenue Code has numerous provisions, involving hundreds of billions of dollars annually, that affect the return to household saving. These include special deductions for retirement saving; dividend and interest exclusions; deferral and exclusion from taxation of unrealized capital gains; and full deductions for both real and inflationary components of interest expenses. Because these provisions were adopted in a piecemeal

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fashion, they are uncoordinated and arbitrary in their distribution of tax reductions among individuals and among different types of assets.

In an inflationary environment, the combined effects of these special purpose provisions become even more random and arbitrary. For example, inflation may increase the tax advantages of saving in the form of owner-occupied housing relative to the advantages conferred by purchases of corporate stock; the reason is that the yield from housing in the form of in-kind services to the homeowner goes untaxed, while the inflation-induced appreciation of stock values may lead to higher capital gains taxes. Such disparities in the treatment of different forms of capital income make the appropriate design of saving incentives especially crucial.

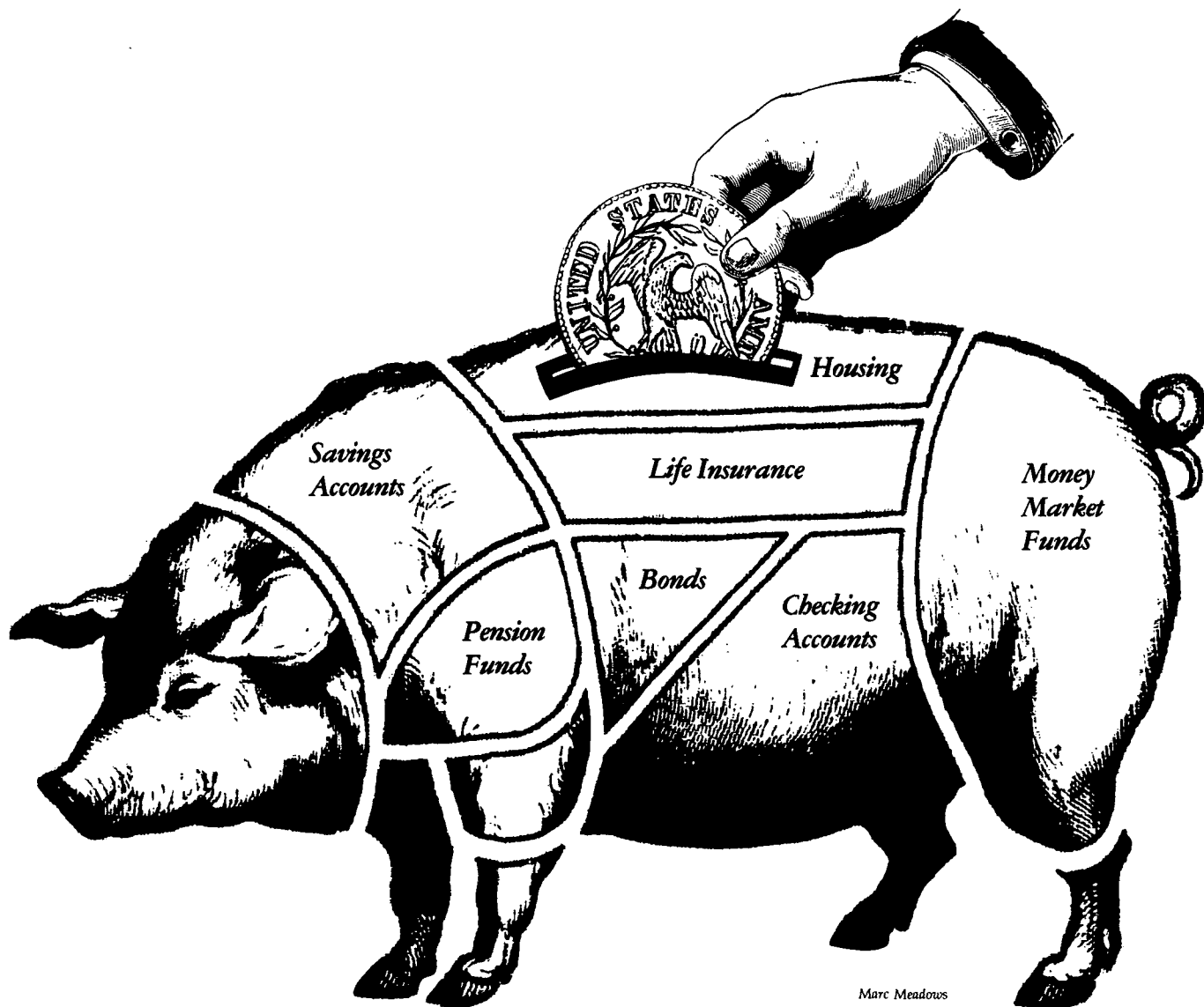


Design Criteria for an Efficient Saving Incentive

For any tax proposal or provision accurately to be labeled a saving incentive, three criteria must be met.

First, tax benefits should not go to taxpayers who simply switch assets from one form of saving (or one kind of account) to another. The shift of assets into a tax-preferred form permits taxpayers to achieve tax reductions with no increase in their saving. When one asset is favored over others, there will indeed be additional investment in the advantaged activity. However, there will also be less investment in other activities and a less efficient allocation of investment across sectors and activities. Thus, although total saving and investment could conceivably increase if overall returns to capital rise, that increase would come at the cost of a poorer allocation of the capital stock.

Second, no tax provision can be considered a true incentive if it does not apply at the margin. A deduction with a cap — that is, one with a limit on the amount of deduction or exclusion permitted — provides little marginal incentive for a person already receiving income in excess of the maximum. For example, a cap of \$500 on the amount of interest or dividends that can be received tax-free would have only a very modest marginal incentive effect, since taxpayers who receive more than \$500 of dividend and interest income account for more than



Marc Meadows

97 percent of such income.

Third, a tax incentive for saving must provide symmetrical treatment of positive saving on the one hand and negative saving or borrowing on the other. If a taxpayer can borrow and deduct the costs of interest while at the same time acquiring an asset yielding income that is partially or fully tax-exempt—a process that is known as “tax arbitrage”—the taxpayer may achieve a tax reduction with no increase in net saving whatsoever.

Imagine a simple case in which the before-tax rate of interest on borrowing and the rate of return from an asset are both 10 percent. Suppose the income from the asset is advantaged through a partial exclusion so that the taxpayer need include only half of the 10 percent rate of return in income subject to tax. Since the interest paid on borrowing can be deducted fully and immediately, the taxpayer has an incentive to purchase the asset — but does not necessarily have an incentive to undertake any net saving. For instance, a taxpayer in the 50 percent bracket who borrows \$10,000 and invests it in the tax-favored asset realizes a subsidy equal to \$250 while engaging in no net saving (column 1 of Table 1 below). If that same taxpayer invests \$10,000 of new saving in the asset, the tax subsidy received still equals only \$250 (column 2 of Table 1). Thus, the tax preference provides no additional return for increasing net saving. This problem can be overcome only if the rule that is applied to positive saving and capital income is also applied to negative saving and capital income. If an interest deduction were allowed only to the extent that the return from an asset were included in taxable income — in the present example, only half of the interest expense would be allowed as a deduction — then a taxpayer would not benefit from engaging in simultaneous borrowing and lending transactions.

Tax arbitrage reduces incentives to save — and incentives to work — in two ways. First, it permits taxpayers to increase their disposable income without doing any additional saving or productive labor — and may, therefore, encourage them to devote more time and resources, including otherwise unnecessary legal and administrative expense, to non-productive efforts. Because tax arbitrage reduces taxable income, it also lowers a taxpayer’s marginal tax rate. However, this effect

on the marginal tax rate results from *any* increases in deductions — not just those deductions that are intended to increase saving. Second, the loss of tax revenues due to arbitrage by some taxpayers necessitates increases in revenue collections from other taxpayers. Those in the latter group face higher tax rates on their labor income and on their income from capital — and, as a result, have somewhat diminished incentives to work and to save.

An inflationary environment intensifies the problems created by tax arbitrage because the deduction of nominal interest payments may result in a *negative* real after-tax borrowing rate. For example, if the interest rate is 14 percent and the inflation rate is 8 percent, the after-tax cost of funds to a taxpayer in the 50 percent bracket is -1.0 percent ($.5(14\%) - 8\%$). Even if the after-tax rate is not negative, the gap between a partially exempt rate of return and the deductible rate of interest will increase with inflation — and so, too, will the potential rewards of arbitrage. Thus, if inflation increases the nominal interest rate (and the cost of borrowing) from 10 percent to 15 percent, a taxpayer in the 50 percent bracket who deposits borrowed money in an IRA will experience a jump in arbitrage profits from \$50 to \$75 for each \$1,000 borrowed. Furthermore, since the taxpayer in such a transaction is both a debtor and a creditor and since inflation will affect both sides of that transaction equally, the taxpayer’s real wealth will not be eroded by inflation. In the IRA transaction just described, the taxpayer’s 50 percent increase in arbitrage profits will be a pure windfall.

The practice of tax arbitrage is neither unusual nor inconsequential. It is quite common for individuals to borrow at the same time that they purchase such tax-favored investments as pensions, annuities, land, or corporate stock. The borrowing may take a variety of forms, including second mortgages, increased leverage in business investments, or decreased equity in housing as an asset when a home is sold and a new one purchased. The asset used as collateral need not be related to the assets actually purchased with borrowed funds. Individuals who borrow will receive the same tax subsidy as those who increase their net saving when they invest in tax-preferred assets.

In summary, for a saving incentive to be effective, it must meet three criteria: little or no inducement to shift forms of asset ownership, a positive incentive to save at the margin, and the prevention of tax arbitrage. We now turn to a review of the saving incentives in current law and an analysis of how well these incentives satisfy our criteria for effectiveness.

Table 1. Example of Tax Arbitrage

	Arbitrager (1)	Saver (2)
A. Earnings on asset	\$1,000	\$1,000
B. Interest paid	1,000	0
C. Change in taxable income before exclusion (A-B)	0	1,000
D. Exclusion or other tax preference	500	500
E. Tax savings	250	250



The Current Taxation of Capital Income

Although proposed new forms of saving incentives have been the subject of public debate and countless congressional hearings in recent years, the extent to which capital income flows are already granted deferral or exclusion from taxation may not be well-known. Many of these preferences have been in the tax law for a

long time and reflect the fact that the tax system generally taxes *realized* flows of cash and excludes or defers from taxation both unrealized accruals of income and receipts of in-kind service flows, such as those from housing and durables.

Perhaps the easiest way to indicate the pervasiveness of these existing incentives is to relate them to the broad categories of assets held by individual taxpayers. As indicated in Table 2 (page 20), there were approximately \$10.5 trillion of these assets at the beginning of 1981, of which roughly \$5.9 trillion were in tangible assets — such as housing, durables, and land — and \$4.5 trillion were in financial assets. Very little of the income from tangible assets held by individuals is taxed. For example, the benefits provided by owner-occupied housing and durables are not subject to tax (although interest payments on mortgages and installment debt are deductible, as are property taxes). Income from investments in real estate is not taxed fully, in part because the owners of these assets are allowed generous investment credits and depreciation or cost recovery allowances.

Much of the total return from both household and business investments in land and real estate consists of appreciation in value. Very little tax is collected on this appreciation because of the capital gains exclusion and, more important, because of provisions in the tax code that defer increases in value from taxation until they are realized and exclude them completely from taxation in the event of death.¹ Taxpayers who are 55 years of age or older also receive a generous exclusion for gains from the sale of owner-occupied housing, while younger taxpayers are allowed to defer such gains by purchasing houses of equal or greater value. We should note, too, that compliance data published by the Internal Revenue Service indicate a substantial amount of underreporting of rental income and income from farms and non-corporate businesses.

Of the \$4.5 trillion held in financial assets, about 21 percent, or \$950 billion, was in the form of life insurance and pension reserves. Most of these assets receive favorable tax treatment because their purchase price is deducted from other income, or the income that they generate is excluded from the tax base, or tax liability for that income is deferred to the future. In addition, 1981 amendments to the tax code permit workers to deduct deposits of up to \$2,000 per year in Individual Retirement Accounts (IRAs).

Another \$1.2 trillion of the financial assets of individuals were held directly in corporate stock. Corporate stock ownership by individuals is given favorable tax treatment through several provisions: the exclusion of 60 percent of long-term gains from taxation; a dividend exclusion of \$100 per taxpayer (\$200 per joint return); a deferral from taxation and an eventual conversion to capital gains for a limited amount of dividends reinvested in public utility stock; and, most important, the combination of tax deferral of any gains until they are realized and the exclusion from taxation of all gains unrealized at the time of a taxpayer's death.

Individuals also held \$74 billion worth of state and local obligations, the income from which is non-taxable, and \$73 billion worth of U.S. savings bonds, the

income from which can be deferred from taxation until the bonds are sold. For years after 1984, a 15 percent exclusion is provided for net interest income of up to \$3,000 (\$6,000 on a joint return), but only to the extent that interest income exceeds itemized interest expenses other than interest paid on debt related to a taxpayer's dwelling or conduct of a trade or business.²

In the aggregate, then, about 80 percent of the \$10.5 trillion in individual assets is held in forms that are subject to some type of "saving" incentive.

Relationship of Existing Incentives to the Criteria for Efficiency

The hodgepodge of provisions relating to the taxation of income from capital may appear at first glance to have moved the tax structure toward some version of a consumption tax. This view is quite misleading, however, because it bypasses the question of whether the existing incentives actually work. Are they efficient according to the three criteria set out earlier?

As to the first criterion — the prevention of asset shifts — saving incentives adopted on a piecemeal basis and applying only to certain forms of saving will almost certainly encourage households to reorganize their portfolios. Because each investment decision will be based partly on tax considerations rather than exclusively on true economic productivity, the overall efficiency and productivity of investment will decline.

One especially important aspect of the efficiency losses induced by asset shifts has been generally overlooked. The exclusion of interest income and payment from most incentives means that individuals are charged the highest effective tax rate for direct lending to others, and a much lower tax rate for holding their saving in other forms.

Financial intermediaries — such as banks and thrift institutions — typically channel money deposited by savers to investors making investments for which economic returns are the greatest. However, when individuals restructure their portfolios to achieve the highest available after-tax returns, this process of financial intermediation is distorted. Lower-income individuals and new businesses are discouraged from borrowing in order to invest, while higher-income individuals and established businesses with current flows of income are encouraged to borrow and to leverage their investments even further or to retain earnings for investment in their own projects. The resulting loss in efficiency occurs not because of shifts in aggregate saving, but because the saving is not made available to those whose potential investments could yield the highest return.

It is clear that inducing individuals to switch their assets from one form to another has adverse economic consequences. Even if saving and investment increase, the resultant net economic benefit is diminished — and perhaps even made negative — by the need for an increase in the capital stock just to offset the misallocation of capital across sectors and uses.

As to the second criterion for effectiveness, current tax preferences for capital income provide no incentive

**Table 2. Assets and
Liabilities of Individuals
in the United States—1981**

*Billions of Dollars Outstanding
at Beginning of Year*

Tangible Assets		\$5,931
<i>Reproducible Assets</i>	\$4,267	
Owner-occupied housing	1,920	
Other residential structures	486	
Consumer durables	995	
Inventories and non-residential plant and equipment	864	
<i>Land</i>	1,665	
Owner-occupied	590	
Farm business and nonfarm noncorporate business	1,032	
Other	43	
Financial Assets		4,521
<i>Currency, Savings Accounts, and Money Market Funds</i>	1,657	
Demand deposits and currency	288	
Time and savings accounts	1,294	
Money market fund shares	74	
<i>Securities</i>	1,644	
U.S. savings bonds	73	
Other U.S. government securities	210	
State and local obligations	74	
Corporate and foreign bonds	87	
Open-market paper	38	
Corporate equities (excluding corporate farms)	1,162	
<i>Pension and Life Insurance Reserves</i>	950	
Life insurance reserves	223	
Pension fund reserves	727	
<i>Miscellaneous Assets</i>	271	
Total Assets		10,452
<i>Home Mortgage</i>	946	
<i>Consumer Credit</i>	385	
<i>Other Mortgage Debt</i>	240	
<i>Other Debt</i>	284	
Total Liabilities		1,855
Net Worth		8,598

Source: *Balance Sheets of the U.S. Economy*
(Washington: Board of Governors of
the Federal Reserve System, 1981).

for increased saving on the margin in situations where a cap is placed on the amount of income eligible for a tax reduction. The current exclusion of \$100 of dividends per taxpayer (\$200 for a joint return) is a prime example. The tax provisions regarding IRAs include both a cap and an inducement to shift assets into tax-preferred accounts. While IRAs may provide some saving incentive for persons whose current rate of saving places them below the cap amount, inevitably those who can most easily obtain the tax reductions that IRAs offer are those who need only to switch the form of their saving, rather than those who actually must increase net saving. Accordingly, it should come as no surprise that in 1977 over half of the eligible taxpayers with incomes over \$50,000 made deposits in IRAs, but less than 5 percent of those with incomes under \$20,000 did so. Data on utilization rates for more recent years are not yet available, but preliminary evidence shows a similar distribution of benefits by income class.

Finally, all of the existing incentives are found to be deficient in terms of the third criterion; none of them effectively disallows tax arbitrage through borrowing. Indeed, much of the interest paid on the \$1.9 trillion of individual financial liabilities is deducted immediately, even though it is likely that many of these borrowed funds are used to acquire assets — such as pensions, annuities, land, housing, and corporate stock — for which income is deferred.

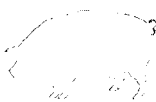
Although the tax law reflects some recognition of the problem of tax arbitrage, restrictions now in the law have had little impact. One provision bars the deduction of interest expenses incurred in borrowing funds used to purchase tax-exempt securities. However, the provision is difficult to enforce. Unless the tax-exempt securities themselves are used directly as collateral for the loan that finances their purchase, it is almost impossible to trace the connection between such a purchase and an increase in borrowing. Moreover, commercial banks and property and casualty insurance companies, which are major purchasers of tax-exempt securities, are ordinarily not affected by this limitation. A second provision limits itemized interest deductions in excess of investment income, but this restriction does not apply to borrowing against one's home or through one's business.

Tax arbitrage is also possible when purchasing physical capital. In many cases, the combination of the investment tax credit and the vastly accelerated depreciation available under the new accelerated capital recovery system (ACRS) provides the equivalent of an immediate deduction for, or expensing of, the acquisition costs of particular investments. Since expensing is tantamount to exempting from taxation the return on investments, failure to deal with the deductibility of interest expenses results in negative tax rates for many leveraged investments.

One further question needs to be addressed: Is it possible that the various preferential tax provisions that we have been discussing, although they are sources of sectoral misallocation when taken one at a time, largely cancel each other out when treated in the aggregate? Three considerations argue against such an outcome. First, as already noted, interest income received by

households is conspicuously absent from the list of items for which tax preferences are allowed. Second, the provisions are so varied in their approach and subject to so many caps and limits that the differentials among rates of taxation (or subsidy) for different types of assets are still quite significant. Finally, the ability to arbitrage the system undercuts any possible incentive effect, since the tax benefits can be obtained without increasing saving at all.

In summary, none of the saving incentives now in the tax code meets each of the three criteria for an efficient incentive: avoidance of unnecessary and inefficient asset shifts, provision of incentives at the margin, and prevention of tax arbitrage through borrowing. Most fail the first test, many fail the second, and all fail the last.



Saving Incentives That Would Work

At this point, one might begin to question whether the tax code is even capable of accommodating an effective saving incentive. We believe that it is, and we offer as evidence three options that would meet all of the above criteria for effectiveness: a comprehensive income tax base conjoined with a reduction in marginal tax rates; a comprehensive personal consumption tax; and the indexation for inflation of income from capital. Particular advocates of these options may not view them as being intended primarily as incentives for saving; nonetheless, as the analysis below will indicate, each option would be an effective means to that end.

Broader-Base, Lower-Rate Income Tax

The adoption of a broader income tax base — and, with it, lower rates of taxation — is a traditional approach to tax reform. This course is supported by those who decry the erosion of the tax base and the attendant adverse impacts on the distribution of tax burdens and the allocation of resources. In terms of our current perspective, however, a broader base and lower rates would also meet all of the criteria for efficient saving incentives. A broader base would provide a more uniform treatment of capital income from disparate sources, thereby improving resource allocation. Saving would be directed toward the most efficient, rather than the most tax-favored, uses. Even if some assets continued to receive tax preferences, lower tax rates would reinforce the tendency toward efficient allocation by automatically decreasing the value of tax-preferred assets relative to other assets.

The remaining two criteria would also be met easily by a broader-base, lower-rate tax structure. The very nature of rate reduction means that incentives would apply at the margin, since marginal tax rates would be reduced for most, if not all, transactions. Finally, the tax arbitrage problem that is characteristic of existing saving incentives would be avoided because the rate reductions would apply equally to both receipts and

deductions. In fact, lower rates would actually reduce the potential gains from tax arbitrage by narrowing any remaining differential between the tax treatment of interest and the treatment of other types of capital income.

There are two aspects of rate reductions that are generally ignored and that make these reductions even better at encouraging saving than is commonly recognized. First, a decrease in rates is one of the easiest ways to reduce the tax incentive to borrow without actually increasing the taxes paid by any borrower. All borrowers with positive net taxable income would benefit from a tax decrease because the reduction in taxes on their positive income would more than offset the increase in taxes on interest payments that are now deductible. Nonetheless, their *marginal* incentive to borrow would be reduced; only taxpayers with zero or negative taxable income, for whom the net tax change would be zero, would have an undiminished marginal incentive to borrow.

Second, in an inflationary economy with high nominal interest rates, a reduction in tax rates would provide a much greater percentage reduction in the tax on real interest income than in the tax on real wages or on the real return from partially taxable assets. For instance, suppose the inflation rate were 7 percent and the interest rate 12 percent. A reduction in a taxpayer's marginal tax rate from 33 percent to 25 percent would initially double the real after-tax rate of return for holding interest-bearing assets (because an increase from 8 percent to 9 percent in the nominal after-tax yield would amount to an increase from 1 percent to 2 percent in the real after-tax yield). However, the rate reduction would increase the return from work by only 12 percent (from 67 cents to 75 cents of each additional dollar earned).

Although the magnitude of potential tax rate cuts would depend on the degree of base-broadening, even modest efforts toward a broader base could represent an improvement over current saving incentives. For example, a more uniform and comprehensive inclusion of capital income in the tax base, offset by a reduction in the corporate tax rate, would be likely to increase efficiency in the allocation of capital across sectors and uses without producing any decrease in net saving. Similarly, returning to the tax base certain forms of labor income now excluded — such as employer payments of health premiums on behalf of employees — would encourage saving if the resultant revenue increases were used to finance a rate reduction for all forms of income.

In terms of saving incentives, perhaps the only objection to a broader-base, lower-rate structure comes from those who fear that taxes on capital income — or taxes paid by those with relatively high propensities to save — would be increased. In a revenue-neutral proposal, for instance, the preponderance of a rate reduction might be directed at labor income, rather than at capital income. Whether capital income would face a higher average tax rate would depend on the particulars of the restructured tax and, in no small part, on how the eliminated tax preferences had been distributed as between capital income and labor income.

There are reasons to discount this objection. First, it

often leads to the type of “saving incentive” proposals that exist today — proposals that would cost revenue and decrease the efficiency of capital allocation, but would have at best an uncertain effect on total saving. Second, a proposal can always be designed to insure that labor income comes in for at least a proportionate share of base-broadening and that taxation of capital income is not increased.

Comprehensive Consumption Taxation

A second effective method of providing a saving incentive would be to convert the existing individual income tax into an individual consumption or expenditure tax. The nature of such a consumption tax should be made clear. In general terms, the tax base would be household consumption, defined as income minus saving. This base could be taxed at progressive rates. Advocates of a consumption tax claim that it is superior to the income tax on a variety of grounds, only one of which is its efficiency as a saving incentive. Our purpose here is not to spell out the details of such a tax or to provide a complete evaluation of its merits and drawbacks, but to indicate the ways in which a comprehensive consumption tax would differ from the piecemeal saving incentives of current law.

A comprehensive consumption tax would meet our criteria for an efficient saving incentive in much the same way as would a broader-base, lower-rate income tax. The *source* of funds for consumption would not affect their tax treatment. Saving would also be treated uniformly; neither the source of the saving nor the type of investment financed by the saving would directly affect the tax rate. Thus, a consumption tax could be considered the equivalent for many purposes of a tax on labor income accompanied by *no* tax on capital income.

Because of its uniform treatment of all capital income and all saving, a comprehensive consumption tax provides a much more efficient saving incentive than does the current tax structure. A consumption tax would be neutral as among forms of saving — in contrast to existing saving incentives, which generally favor one form of saving over another. In a consumption tax, incentives would apply at the margin for all taxpayers; even for the wealthiest of individuals, the tax rate for income from saving would in effect be zero. Few saving incentives now in the tax code meet that second criterion. Finally, while existing incentives all increase the benefits that can be obtained by borrowing and simultaneously investing the proceeds in a tax-favored asset, a properly designed consumption tax would address the tax arbitrage problem directly by eliminating the deduction for interest paid or by treating all borrowed dollars as receipts (and gross saving as deductions from receipts).

Indexation of Capital Income

A third option — and one not generally considered a saving incentive — would be the indexation for inflation of all capital income.³ Full indexing of capital income would mean that all depreciation deductions

would be adjusted for increases in the price level that take place after the purchase of the depreciable asset; real, rather than nominal, capital gains would be subject to taxation, and only the real component of interest income or expense would be added to or subtracted from the tax base.

Indexing can be supported as a tax reform measure on more or less the same grounds as base-broadening — namely, that the more accurate measurement of income would increase the efficiency of resource allocation and tend to equalize the tax burdens of individuals with equal amounts of real income. But it is also possible for indexing to be a saving incentive, although its force as an incentive would depend upon whether marginal rates on all capital income were raised or lowered. If marginal rates were raised — as in the case of base-broadening with no corresponding rate reduction — then the outcome would be ambiguous and would turn on whether the improvement in the allocation of capital across uses was more than offset by the losses associated with a reduction in aggregate investment. However, if average marginal tax rates on capital income were lowered, the gains from increasing the aggregate capital stock would reinforce the gains from improving its allocation.

As one component of an effort to measure and to tax all real income uniformly, indexing would fulfill all the criteria for an efficient saving incentive. First, it would reduce the unnecessary asset shifts that occur under the existing tax rules. Second, to the extent that real after-tax returns would be increased, the incentives to save would be applied at the margin. Finally, the indexing of capital income would reduce the potential rewards of tax arbitrage by allowing the deduction of only real interest expenses (even as it would permit the taxation of only the real component of interest receipts).

There are several advantages to providing incentives for saving through full indexing. Because indexing would affect capital income only, a revenue-neutral tax program containing full indexing could be designed to avoid raising the average marginal tax rate on capital income — an outcome feared by many of those who oppose the creation of a broader-base, lower-rate income tax structure. At the same time, indexation would work within the context of the income tax; it would neither remove real capital income from the tax base nor exempt wealth accumulation from taxation, as would a consumption tax. Finally, indexation would meet almost everyone's standards of fairness, because it would be a move toward the more accurate measurement of income.

Many of the existing tax preferences for capital income were adopted as crude forms of indexing or have had the effect, whether intended or not, of moderating the tendency of inflation to change real effective tax rates across assets. However, such ad hoc indexing operates in an imperfect, uneven, and haphazard way; some assets are fully or partially shielded from inflation and others are essentially exposed. Among the current instances of ad hoc indexing are: for fixed physical capital, accelerated depreciation and the investment tax credit; for inventories, the last-in-first-out (LIFO) method of accounting; and for corporate stock and other

assets that appreciate in value, deferral and exclusion of realized capital gains. Of the various types of capital income, interest is least protected and thus the most vulnerable to the effects of inflation.

Short of comprehensive indexation, there are two ways in which the existing system of ad hoc indexation could be brought closer to conformance with our criteria for efficiency. First, improvements could be made in how indexing is provided for particular items of income. For instance, the current method of accelerated depreciation — which results in highly disparate tax rates being imposed on different types of capital income — could be replaced with an adjustment that would lower tax rates simply by assuring that inflation does not reduce the real value of allowed deductions.

Second, even partial indexation of interest income would reduce significantly the existing incentive for asset shifts and portfolio reallocations. A concomitant indexation of deductible interest expense would decrease the incentive to borrow and reduce the gains that can be realized through tax arbitrage. One possibility would be fractional inclusion of both interest income and expense — with lenders paying tax on only a portion of their nominal interest receipts, and borrowers deducting only a portion of their nominal interest payments; this arrangement would clearly measure net real income more accurately than does current law.



Conclusion

Although the tax code contains numerous provisions that are designed to provide incentives for saving, virtually none of them meets the criteria for an effective incentive. Most cause unnecessary and inefficient asset shifts, many fail to provide incentives at the margin, and all permit tax arbitrage through borrowing.

As we have seen, however, it is possible to design an effective incentive; three comprehensive options were delineated above. Short of these more thoroughgoing measures, partial reforms in the direction of a more uniform treatment of income, additional rate reductions, and the indexation of interest could provide some enhancement of saving incentives. We would emphasize, however, that the top priority for designers of tax incentives — and one that has been neglected for too long — should be the revision of interest deductibility rules in order to minimize the opportunities for tax arbitrage.

1. This exclusion applies to heirs as well as to decedents and is achieved by increasing the heir's basis in an asset to the asset's value at the time of the decedent's death.

2. This provision has not yet come into effect, and many bills now before Congress would defer or eliminate it.

3. We are considering here the effects of inflation on the size of the tax base and on the measurement of real income; we are not examining the so-called "bracket creep" effect.

Andrew Heiskell on the Press



Andrew Heiskell retired in 1980 as chairman of the board and chief executive officer of Time Inc., having served in the former position since 1960 and the latter since 1969. He had begun his career with the company in 1937, as science and medicine editor of LIFE magazine. He currently serves as vice chairman of the board of the Brookings Institution and chairman of its executive committee. During a recent visit to Brookings, he discussed the performance of the press and some of the challenges that it faces.

Q As a general matter, how well are the media doing the job of informing the public about what's going on in the world?

How well they're doing that job depends in part upon how much attention the public pays to the media. If you want to be well-informed, there are plenty of sources of information out there on virtually any subject. In fact, there's such a proliferation of communications media that it could even be discouraging to people.

If, say, you read one tabloid a day or you look at only one TV news program a day, the odds are that you're not very well-informed. But the media do not decide what you are going to read or watch. You decide that.

Of course, there is another side to the equation: The press does try — because it has to try — to package news in a way that makes it interesting to the reader. The publication that is successful in making news uninteresting is not going to be around very long.

Q Over the years, the magazines of Time Inc. seem to have reflected a conviction that the best way to make news interesting to readers — and intelligible to them — is to describe events and trends in terms of the people involved. What are your thoughts on that approach?

You can look at the news in two ways: first, in terms of issues, and, second, in terms of personalities — the people who are involved in the issues. Given that readers are also people, the odds are that they're going to relate more readily to news that is presented in terms of the actors on the scene than to a report that says, for example, that the issue in Lebanon is that there are 3,453 different religious groups. Personalizing news does make it easier to latch onto.

The ultimate in that, of course, is *People* magazine, which literally says that it's going to tell you about what's going on using an entirely different cut — namely, a people cut. Now, obviously, *Time* magazine doesn't use only a people cut. But *People* does, and it conveys quite a lot of information. It probably leaves out quite a lot of information, too.

By the way, the most obvious example of personalized news coverage is the way that the president in this country has become a focal point and a symbol. We all know perfectly well that the president doesn't do all by himself everything that is attributed to him. But the system requires that it be the president who appears to be doing all these things — and, therefore, every day the headlines are "the president says" or "the president does."

Q Let's talk about the coverage of international developments. You mentioned Lebanon, where the circumstances and the issues are obviously very complicated — and very confusing. How well has the press done in its efforts to explain that situation?

Well, having been in Lebanon quite a bit over the years, I'd venture to say that probably the worst mistake that the government or the press could make would be to suggest that there is a simple solution to the problems in Lebanon.

Is it the fault of the press that people don't really understand what is taking place in Lebanon? The answer, I think, is no. Lebanon is divided into so many sects of religious fanatics that I would hesitate to try to

enumerate them. And until you understand all of the religious issues that pop up anytime that things are not calm in Lebanon, you're not going to know how to react. The situation is so wildly complex that I just wouldn't expect 220 million people ever to understand it.

And I wouldn't fault anybody for not being very clear about explaining Lebanon. So the answer is that the press is probably not doing a good job on Lebanon — but, on the other hand, I doubt that it's *possible* to do a very good job on Lebanon.

⑤ Another area of the world in which the United States has been heavily involved in recent months is Central America — and polls indicate that large segments of the public don't know which side we were on in such places as El Salvador and Nicaragua. To what extent can the press be faulted for this basic lack of understanding?

Well, obviously we're doing an inadequate job. I tried for 25 years, through the Inter-American Press Association, to arouse interest in Latin America — and that effort was a complete failure. The reason is that the U.S. thinks East-West; it doesn't think North-South. We pay no attention to Latin America. When something explodes in Latin America, we give it one day's worth of attention and then our minds, like the needle of a compass, just flick back to East-West.

So when something does go wrong in Central America, we have no background, we have no knowledge, we have no understanding. When you have no background, knowledge, or understanding, the headlines are apt to be confusing — and politicians are apt to be saying the wrong things.

⑥ What was the impact of Grenada on the press?

The U.S. press was blocked for the first time by the U.S. government from covering an invasion by U.S. troops. It was a dangerous precedent. Unfortunately, the press's cries of outrage seemed to make little public impact. As a result, the administration will be more likely to repeat its censorship next time.

⑦ During your years at Time Inc., did readership surveys turn up any systematic tendency for people to read foreign policy news more or less than domestic news?

No, but if you go back to before World War II, *Time* magazine, like the U.S., had very little interest in foreign affairs. That interest developed as a result of the war, when many millions of Americans went abroad for the first time. When they came back, you had a built-in audience for foreign news.

Actually, *Time* had a pony edition that went to the troops during the war — a little one, without advertising, weighing about two ounces. And the troops complained about there being no advertising. They said, "What we really want to know about the U.S. is what products you can buy."

In any case, Americans kept going abroad after the war. Everybody thinks that there must be some logical basis for the way you do these things. It's not that logical. You tend to follow what's happening, and one of the things that happened was that Americans went abroad and became interested in the world.

For about 25 years after the end of the war — that is,

until about 1970 — there was considerable interest in what was going on abroad. Then it started to slide off, and now it's at a lower level.

⑧ In addition to foreign affairs, another category of news that seems to baffle people is economics. How can the press help people to understand the significance of a \$200 billion deficit or the implications of the global debt situation?

Part of the problem is that economic issues are not particularly suited for treatment in personality terms. Indeed, that's essentially why Paul Volcker is as fam-



ous as he is now. He has come to personify somehow the issues of interest rates and deficits — and the way you get at those issues is to show that great big hulk of a man with his cigar. Another difficulty is that economists are mainly academics and don't really approve very much of their profession being popularized.

Incidentally, you have to remember that 30 years ago there was practically no coverage of business — not to mention economics — other than in specialized magazines. Over the past 30 years, most publications have beefed up their business coverage very considerably. As that happens, you inevitably slip into reporting on economics — because business is affected by a \$200 billion deficit, for example.

⑨ What do you think of the trend toward hiring specialists — economists, foreign policy experts, and so on — to cover the news?

The question is whether these specialists can communicate clearly. When *Fortune* was started, it was the first general business magazine — and it was launched with a staff of people who really understood quite a lot about business. After a while, we decided that [Archibald] MacLeish was better. It was easier for MacLeish to learn about business than it was to teach a business character to write English.

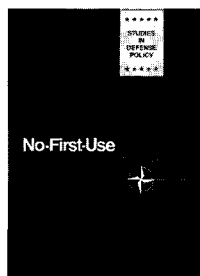
Of course, there are exceptions — specialists who communicate very well indeed. Dr. Lewis Thomas, a reputable scientist, writes books as well as articles for *Discover* magazine that put ordinary journalists to shame.

No First Use of Nuclear Weapons: Perspectives on a Controversial Proposal

Alliance Security: NATO and the No-First-Use Question

Edited by John D. Steinbruner and Leon V. Sigal

222 pages. \$9.95 paper; \$28.95 cloth.



ACCORDING TO THE CONTRIBUTORS to this collection of essays, deterrence of conventional attack without recourse to nuclear weapons is a feasible alternative, politically as well as militarily, to NATO's present strategy and force posture on the Central Front in Europe. They conclude also that the largest component of NATO's nuclear arsenal — short-range weapons for use on the battlefield — actually detracts from, rather than reinforces, the strength of NATO's conventional forces.

The book — edited by John D. Steinbruner, director of Foreign Policy Studies at Brookings, and Leon V. Sigal, a Brookings guest scholar and professor of government at Wesleyan University — focuses on the ramifications of a policy of "no first use" of nuclear weapons. A joint project of Brookings and the International Institute of Strategic Studies (IISS) in London, the study draws on analysts who have participated in the development of NATO defense policy on both sides of the Atlantic.

Throughout the Alliance's existence, reliance on nuclear weapons was premised on two assumptions: first, that NATO's conventional forces were too weak to deter attack, and, second, that increases in those forces sufficient to close the gap were not politically realistic. A detailed assessment by William W. Kaufmann, a Brookings consultant and professor of political science at MIT, calls both assumptions into question.

Kaufmann finds that the Warsaw Pact's oft-rehearsed numerical advantages in organized divisions and in tank and tactical aircraft inventories do not translate into a decisive capability to invade Western Europe — and that NATO and Warsaw Pact manpower and financial investment levels are not as disparate as they once seemed. Using methods of calculation employed by both Soviet and American military professionals, he estimates that the chances of a successful Warsaw Pact attack on Western Europe are great enough to cause concern in NATO but not so great as to allow the Soviet Union to contemplate aggression with confidence. Under the current balance, neither side can anticipate with assurance what the outcome of conventional war in Europe would be. Conventional deterrence rests on this mutual uncertainty.

Kaufmann identifies investments in NATO forces that would reduce the chances of successful attack on NATO to very low levels — and that could be accomplished within the current guidelines of three percent increases in NATO defense budgets. These investments, according to Kaufmann, are the most attractive options for increasing the overall security of the Alliance.

In a qualitative analysis that complements Kaufmann's quantitative one, Colonel Jonathan Alford, deputy director of the IISS, identifies three trends that argue for bolstering NATO's conventional deterrent: the reduced credibility of NATO's nuclear deterrent; the continued high rate of Warsaw Pact investment in conventional forces; and the American assumption of security burdens outside Europe, which tends to shift more responsibility for NATO security onto European shoulders. Yet Alford finds it "hard to be optimistic that NATO will substantially improve" its conventional efforts under current political and economic constraints.

David N. Schwartz, a former research associate in Foreign Policy Studies at Brookings, notes that in the past these constraints have compelled NATO more often than not to increase its reliance on nuclear weapons beyond what might be justified by its strategy.

The study also finds that the commingling of nuclear and conventional forces in its posture prevents NATO from drawing on the full measure of its conventional strength. Dual-capable systems, in Sigal's assessment, put field commanders in a predicament: "Anticipating escalation, they might withhold or withdraw dual-capable forces from the conventional battle in order to ready them for nuclear missions. The temptation would be greatest when the conventional conflict is most intense and its outcome most uncertain — precisely when the maximum conventional effort is most urgently needed." This observation applies especially to short-range systems, the most vulnerable part of the NATO arsenal.

While this assessment is shared within the Alliance, there is continuing disagreement about the desirability of change. According to Johan Jorgen Holst, director of the Norwegian Institute of International Affairs, "Europeans are concerned above all with the prevention of war. They have resisted American proposals for conventional defense in the past in part for economic reasons, but in part also for fear of making Europe 'safe for conventional war.'" Yet public unease in Europe over the consequences of implementing NATO's present strategy threatens to create a crisis of confidence about security policy in general and coalition defense in particular. "For the sake of reassurance," Holst writes, "nuclear weapons should be a means of last and not of first resort." He identifies a number of options short of formal adoption of no first use, ranging from a change in declaratory policy, through putting the principle of no first use into practice without formally changing NATO's strategy of flexible response, to a gradual embrace of a "no *early* first use" strategy.

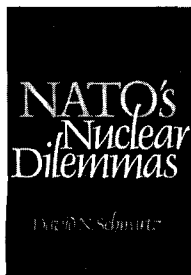
As a practical matter, improvements in NATO's conventional defenses and reduced reliance on nuclear weapons depend upon the political and economic judgments made in Europe. Three Germans — Gert Krell, an assistant director at IISS, and two colleagues of his at the Hessian Foundation for Research on Peace and Conflict, Thomas Risse-Kappen and Hans-Joachim Schmidt — address these matters from the vantage point of a non-nuclear power whose defense arrangements are intimately tied to and dependent on NATO. They find an emerging elite consensus in West Germany opposed to formal adoption of no first use, yet in favor of raising the nuclear threshold. That consensus is tempered, they add, by skepticism about an expansion of conventional defense efforts.

In a closing chapter that summarizes the findings of the study, Steinbruner observes that "the arguments for altering NATO's reliance on nuclear weapons are too powerful to be dismissed with no effect whatsoever, though the necessary changes are too fundamental for all of them to be implemented immediately."

Nuclear Weapons and NATO's Defense Posture

NATO's Nuclear Dilemmas

By David N. Schwartz. 270 pages.
\$10.95 paper; \$28.95 cloth.



IN DAVID N. SCHWARTZ'S JUDGMENT, the deployment of new nuclear missiles in Europe is likely to fuel, rather than quell, the ongoing debate within NATO over the role of nuclear weapons in the defense of Western Europe. The new missiles, he writes, will not put to rest long-standing doubts among our allies about the credibility of deterrence that relies on U.S. weaponry, nor will they allay fears that the introduction of more U.S. nuclear arms into Western Europe further entangles that region in the possibility of global cataclysm.

Schwartz reviews in detail the events and decisions leading up to the NATO decision in December, 1979, to deploy new nuclear missiles in Europe and to engage the Soviet Union in arms control negotiations regarding such weapons. He sets the decision against the background of five previous nuclear initiatives considered by NATO: the offer of Thor and Jupiter intermediate-range missiles to the allies in 1957-58; the proposal for a mobile,

land-based intermediate-range missile for the Alliance in 1958-60; plans for the creation of a sea-based multilateral nuclear missile force for the Alliance in 1961-65; the proposal and subsequent adoption by NATO of the doctrine of flexible response in 1962-67; and the creation of the NATO Nuclear Planning Group in 1965-67.

His analysis of NATO's recent decision suggests that the Alliance has learned some important lessons from those cases, including the necessity of consistent U.S. leadership; the value of intimate and frequent consultations between the U.S. and its allies; the wisdom of multiplying the president's strategic and conventional options for dealing with crisis and war; and the practical role of ambiguity in the articulation of doctrine.

With the stakes now so high, says Schwartz, it is essential to implement NATO's decision of 1979. In particular, "the arms control part of the decision can moderate the planned deployment, reduce the threat to the NATO allies, and make deployments less controversial." In this way, he suggests, the Alliance can reduce the political costs entailed by the decision and moderate the Soviet response to deployment.

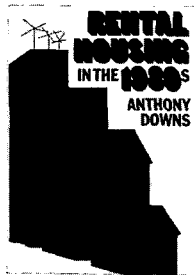
He adds that a complementary policy "could be built on the observation . . . that the nuclear posture of the Alliance, and the U.S. willingness to use its terrible arsenal in defense of its allies, is manifestly more credible if the Alliance has a strong enough conventional posture to force the Soviet Union to contemplate using nuclear weapons to achieve its military objectives."

Schwartz, until recently a research associate in the Brookings Foreign Policy Studies program, is now deputy director of policy analysis in the State Department's Bureau of Politico-Military Affairs.

No Room at the Inn: The Shortage of Rental Housing

Rental Housing in the 1980s

By Anthony Downs. 202 pages.
\$9.95 paper; \$26.95 cloth.



ACCORDING TO ANTHONY DOWNS, it is likely that in the remainder of this decade demand for rental housing will continue to increase, growth in the supply of rental housing will remain slow, and the prices charged to renters will continue to jump up faster than the Consumer Price Index.

At present, just over one-third of all households occupy rented quarters. But this proportion can be expected to increase in the 1980s, writes Downs, because high real interest rates will discourage home purchases. In the 1970s, by contrast, real interest rates were substantially lower and the ranks of homeowners grew more rapidly.

As the demand for rental housing edges up, the supply is tightening. In the mid-1970s, the rate of construction of new rental units dropped sharply from the levels characteristic of the early 1970s — and the rate has stayed at these lower levels ever since. Downs suggests that investment in rental housing had been profitable in those earlier years because of four factors: the availability of tax sheltering advantages, low real interest rates, the opportunity to enjoy high degrees of leveraging with borrowed funds, and the expectation of rapid appreciation in the value of rental units. While tax sheltering advantages remain, high real interest rates have now reduced the profitability of leveraging, and investors can no longer realistically expect rapid appreciation in property values.

That means that the profits of those who do develop new rental units now depend more heavily than in the past on rental income — which, Downs notes, is one reason why in every month since January, 1982, rents have risen more rapidly than the Consumer Price Index as a whole. Downs anticipates that this trend will continue for at least several years. Rising

rents will hit poor families especially hard — and at a time when federal assistance to the poor has been scaled down — because home rent is their single biggest expense.

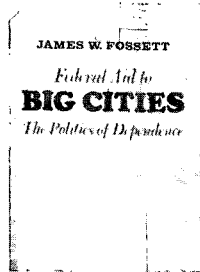
As rents continue to rise, in many localities political pressures for programs of rent control will rise also. But these pressures should be resisted, says Downs, because rent control “only increases the shortage of rental housing and the deterioration of the existing rental inventory.” He advocates instead a combination of initiatives: first, a federal prohibition of local rent controls; second, a federal housing allowance or voucher program for rental households with incomes less than half the median income in their localities; and, third, a modest reduction, which would finance the voucher program, in the tax benefits now accorded homeowners.

Downs is a senior fellow in the Economic Studies program at Brookings. He is the co-author, with Katharine L. Bradbury and Kenneth A. Small, of another recent Brookings book: *Urban Decline and the Future of American Cities*.

Federal Funds, City Programs

Federal Aid to Big Cities: The Politics of Dependence

By James W. Fossett. 59 pages.
\$5.95 paper.



JAMES W. FOSSETT, drawing on case studies of eleven major U.S. cities, finds that the Reagan administration's cutbacks in urban aid have had a smaller adverse effect on cities than had been anticipated. The primary reason for this outcome, he says, is that cities anticipated the cutbacks and attempted to insulate themselves against their impacts. Even the cities that are hard-pressed financially have been able to adapt.

Fossett's book summarizes and interprets the results of a series of research projects, conducted under the auspices of the Brookings Governmental Studies program, on the extent to which cities have become dependent on federal aid. The cities studied were Boston, Chicago, Cleveland, Detroit, Houston, Los Angeles, New York, Phoenix, Rochester, St. Louis, and Tulsa. Fossett, who is now on the staff of the Institution of Government and Public Affairs at the University of Illinois, is a former Brookings research assistant.

Fossett argues that a city's dependence on federal funds is a function of the city's fiscal condition, the amount of discretion it has in using federal funds, and the level of political organization among the beneficiaries of federal programs. He identifies three distinct patterns among the eleven cities studied. The first pattern is found in six cities classified as financially hard-pressed: Boston, Cleveland, Detroit, New York, Rochester, and St. Louis. In these localities, federal funds have become major sources of support for ongoing city activities — including, especially, the provision of basic services — and sources as well of political capital for city officials.

The second pattern surfaces in Chicago and Los Angeles, where federal aid has not been used to finance basic city services, but where the allocation of that aid has nonetheless been closely tied to local politics. During the 1970s, Fossett says, both cities were in relatively healthy financial circumstances, which made it possible for them to separate the activities supported by federal funds from those supported by local revenues.

Houston, Phoenix, and Tulsa exemplify a third pattern of federal aid use. In these cities, federal funding has not become either a major source of support for city services or a focal point of local political maneuvering. The three cities have in the main used federal funds to finance new services, such as manpower or community development programs, that they were not providing before federal support became available.

Brookings has published, in addition to Fossett's book, four of the city-specific case studies: *Federal Aid to Chicago*, by Charles J. Orlebeke; *Federal Aid to Detroit*, by Thomas J. Anton; *Federal Aid to Houston*, by Susan A. McManus; and *Federal Aid to St. Louis*, by Henry J. Schmandt, George D. Wendel, and E. Allan Tomey.

Federal Aid to Chicago

By Charles J. Orlebeke. 80 pages. \$5.95 paper.

Federal Aid to Detroit

By Thomas J. Anton. 55 pages. \$5.95 paper.

Federal Aid to Houston

By Susan A. McManus. 59 pages.
\$5.95 paper.

Federal Aid to St. Louis

By Henry J. Schmandt, George D. Wendel, and E. Allen Tomey. 67 pages.
\$5.95 paper.

Conference on Arms Control

ON NOVEMBER 9, the Advanced Study Program at Brookings held a National Issues Forum on the options and prospects for arms limitations. The one-day conference addressed such topics as the dynamics of arms control negotiations; the relationship of arms control to U.S. security policy; and the special issues involved in negotiations regarding strategic nuclear weapons, intermediate nuclear forces, and conventional forces.

Among the speakers at the forum were two former directors of the Arms Control and Disarmament Agency (Gerard C. Smith and Paul C. Warnke) and several members of Congress (Senator Joseph R. Biden, Jr., Representative Les Aspin, and Representative Jim Leach). Other speakers included John D. Steinbruner, director of Foreign Policy Studies at Brookings; Lawrence J. Korb, assistant secretary of defense for manpower, reserve affairs, and logistics; James F. Dobbins, Jr., deputy assistant secretary of state for European affairs; William H. Kincade, executive director of the Arms Control Association; David N. Schwartz, deputy director of policy analysis in the State Department's Bureau of Politico-Military Affairs; and William J. Taylor, Jr., of the Center for Strategic and International Studies at Georgetown University.



Paul C. Warnke



above: Gerard C. Smith



above right: David N. Schwartz and William J. Taylor, Jr.

right: James F. Dobbins, Jr.; John D. Steinbruner; and Peter Malof of the Advanced Study Program at Brookings.



below: Senator Joseph R. Biden, Jr., and William H. Kincade



The Advanced Study Program at Brookings: Upcoming Events

The Advanced Study Program has two purposes. The first is to provide continuing education to America's leaders — in business, government, and non-profit organizations — about current issues of domestic and foreign policy, in the expectation that a better understanding of these issues will help people in positions of

responsibility to operate more effectively. The second is to stimulate informal discussions among leaders from different sectors of society, in the hope that the exchange of insights can help to produce wiser public policy.

National Issues Forum: Changes in the Scope and Structure of Domestic Financial Institutions.

Date: February 1, 1984, 9 a.m. to 5 p.m.

National Issues Forums are one-day programs, held at Brookings, on current issues of major importance. They offer participants a chance to explore those issues thoroughly in a give-and-take with top government officials and policy experts.

The February 1 Forum will focus on the impact of recent banking deregulation legislation on the financial community. Among the topics to be considered are the changes taking place or about to surface in commercial banking and in the structure of consumer financial services; the opportunities in the financial marketplace for securities and insurance companies; and the future legislative agenda for financial institutions.

Scheduled speakers include:

Richard C. Aspinwall, *vice president of the Chase Manhattan Bank*

Richard C. Breeden, *deputy counsel to Vice President Bush*

Andrew S. Carron, *senior fellow in the Economic Studies program at Brookings*

Senator Jake Garn, *chairman of the Senate Committee on Banking, Housing and Urban Affairs*

Edwin Gray, *chairman of the Federal Home Loan Bank Board*

Representative Henry B. Gonzalez of the House Committee on Banking, Finance and Urban Affairs

William H. Kennedy, Jr., *chairman of the American Bankers Association Council*

Edward I. O'Brien, *president of the Securities Industry Association*

Richard T. Pratt, *president of Merrill Lynch Mortgage Capital Markets, Inc.*

The "Investment in Leadership" Series: Understanding Federal Government Operations

Dates:

January 8 to 13, 1984

February 5 to 10, 1984

March 4 to 9, 1984

March 18 to 23, 1984

April 1 to 6, 1984

May 6 to 11, 1984

May 20 to 25, 1984

June 3 to 8, 1984

June 17 to 22, 1984

Corporate success in the 1980s requires an understanding of the increasingly complex national and international corporate environment. Federal policies — on fiscal and monetary matters, international trade, regulatory issues, and so on — have important impacts on that environment.

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This program is accredited by the American Council on Education for two semester hours of graduate level credit in the field of business-government relations.

The fee for the February 1 National Issues Forum is \$260. The fee for attendance at one of the six-day conferences on federal government operations is \$1,825. Fees include meals and materials, but not lodging. Advance registration is required. To reserve a space, send payment or billing instructions to:

Registrar, Advanced Study Program
The Brookings Institution
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